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Supreme Court, U.S.
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No.

In the Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the Ninth Circuit, in direct conflict with the Eighth Circuit, correctly concluded that Treas. Reg. § 1.861-8(e)(3), which governs the allocation of research and development costs between foreign and domestic income, may be applied to the computation of taxable income for export subsidiaries entitled to special tax treatment under the Internal Revenue Code.

RULES 14.1 AND 29.6 STATEMENT

The parties to this proceeding are The Boeing Company and Consolidated Subsidiaries and Boeing Sales Corporation. Boeing Sales Corporation is a wholly-owned subsidiary of The Boeing Company. No publicly held company owns 10% or more of The Boeing Company's stock.

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PETITION FOR A WRIT OF CERTIORARI

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*,1a-14a) is reported at 258 F.3d 958. The opinion of the district court (App., *infra*, 15a-24a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 2, 2001, and a timely petition for rehearing was denied on November 19, 2001 (App., *infra*, 25a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The relevant provisions of 26 U.S.C. § 994, 26 U.S.C. § 861, 26 C.F.R. § 1.994-1, and 26 C.F.R. § 1.861-8 are reprinted in the appendix to this petition at 26a-53a.

STATEMENT

This case concerns successive sets of tax provisions enacted by Congress to encourage exports by partially deferring or exempting taxation of income from export sales. Two principles control the measurement of the export income eligible for this special tax treatment. First, expenses are to be deducted from the export sales income to which those expenses are factually related, rather than from other gross income to which the expenses are not factually related. Second, to maximize tax benefits and thus to enhance the export incentives, taxpayers are permitted to group their income and expenses by recognized industry product line classifications.

The decision below departs from both of these principles. Under the rule announced by the Ninth Circuit, taxpayers are required to allocate or apportion research and development ("R&D") expenses according to broad groupings rather than

product lines, and they must do so in ways that result in substantial R&D costs being deducted from income to which the R&D is *not* factually related. In this case, the court of appeals' holding resulted in the reallocation of some $2 billion of petitioner Boeing's R&D costs, thereby increasing Boeing's tax liability by more than $400 million. This decision frustrates the Nation's trade policy by diluting a significant economic stimulus measure; it also expressly conflicts with a decision of another court of appeals and therefore leaves companies uncertain of the tax benefits they may obtain by expanding their export activities. Further review is plainly warranted.

1. In 1971, Congress enacted a set of provisions that were designed "to provide tax incentives for U.S. firms to increase their exports," a program that was thought important both for its "stimulative effect" and "to remove a * * * disadvantage of U.S. companies engaged in export activities." H.R. Rep. No. 533, 92d Cong., 1st Sess. 58 (1971). See *Caterpillar Tractor Co.* v. *United States*, 589 F.2d 1040, 1044 (Ct. Cl. 1978). The "provisions were designed to neutralize some of the tax advantages for [European] exporters inherent in European territorial-type tax systems, which generally exempt all income earned outside the country from income tax and all exports from value-added and other consumption taxes." *Hearings on Trade Relations with Europe and the New Transatlantic Economic Partnership Before the Subcomm. on Trade of the House Comm. on Ways and Means*, 105th Cong., at 116 (1998) (statement of Jeremy O. Preiss, Chief International Trade Counsel, United Technologies Corporation).

Under the U.S. program, corporations were permitted to create special subsidiaries known as "Domestic International Sales Corporations" ("DISCs"). Income from export sales made through DISCs received partial tax deferral. IRC §§ 991-997.[1]

[1] In particular, a parent corporation could assign a portion of its otherwise taxable export income to its DISC subsidiary. The parent then was taxed only on the income it retained and a specified portion of the DISC's income. Tax was deferred on the DISC's remaining income either until it was distributed to the parent corporation or until the DISC ceased to meet statutory requirements (see IRC § 995(a), (b)). In 1984, Congress granted complete exemption from taxation to all DISC income that had not yet been taxed at that time. See Deficit Reduction Act of 1984, § 805(b)(2), Pub. L. No. 98-369, 98 Stat. 494.

As a consequence, "[t]he greater the DISC profit, the larger the amount of tax-deferred income * * * . Thus, a [corporation creating a DISC] had an incentive to *maximize* DISC profit." *St. Jude Medical, Inc.* v. *Commissioner of Internal Revenue*, 34 F.3d 1394, 1397 (8th Cir. 1994) (emphasis added).

In 1984, the DISC regime was replaced by one making use of Foreign Sales Corporation ("FSC") subsidiaries. See Deficit Reduction Act of 1984, §§ 801-805, Pub. L. No. 98-369, 98 Stat. 494. After the FSC regime, like the DISC regime, was declared to violate global trade rules, Congress responded by enacting the Extraterritorial Income Exclusion Act of 2000 ("ETI"). Each of the three regimes differs slightly from its predecessor, but none of the differences is relevant to the issues presented in this case. In each regime the mechanics of determining tax-favored income are substantially identical; in particular, each regime provides for grouping of income and deductions by product or product line.[2]

Under each of the three regimes, it is crucial to determine the income that is attributable to export sales and therefore qualifies for favorable tax treatment. The DISC statute "permitted a taxpayer to use one of three methods for determining the amount of deemed profit allocated to the DISC and its parent as a result of export sales. The taxpayer/parent

[2] The years at issue in this case involve the DISC and FSC provisions. Because the parties have agreed that there are no differences between DISC and FSC relevant to this case, for purposes of clarity we limit our discussion to DISC and refer to the Internal Revenue Code (26 U.S.C.) as in effect in 1979, unless otherwise indicated. The court below did this as well. See App., *infra*, 6a n.3.

could choose the method resulting in the greatest amount of profit [for the DISC]." *St. Jude Medical*, 34 F.3d at 1397. See IRC § 994; H.R. Rep. No. 533, *supra*, at 59 ("special pricing rules in the bill permit a DISC to earn a larger relative amount of the profit on sales by the DISC of its parent company's export products"). One of these methods, which was used by petitioner Boeing in this case, is known as the "combined taxable income" (or "CTI") method. IRC § 994(a)(2).

The DISC statute provides generally that, under the CTI method, a DISC is allocated a set portion of "the combined taxable income of [the] DISC and [its parent corporation] which is attributable to" export sales. IRC § 994(a)(2). The statutory language does not define "attributable to" or "combined taxable income" – and, in particular, does not explicitly address how expenditures are to be deducted from gross export receipts when calculating net export income. See *St. Jude Medical*, 34 F.3d at 1398. But that question is addressed in detail both by the legislative history of the DISC statute and by regulations prescribed by the Secretary of the Treasury pursuant to the statute.

The committee reports accompanying the DISC legislation contemplate that all expenses fall into one of two categories that receive differing treatment in the calculation of CTI. CTI is to be "determined by deducting from the DISC's gross receipts" [1] *all* "expenses * * * which are *directly related* to the production or sale of the export property and [2] *a portion* of the * * * *expenses not allocable to any specific item of income*, such portion to be determined on the basis of the ratio of the combined gross income from the export property to the total gross income of the [parent corporation] and the DISC." H.R. Rep. No. 533, *supra*, at 74 (emphasis added). This directive was faithfully implemented by the DISC regulations, which define CTI as "the excess of the gross receipts * * * of the DISC * * * over the total costs of the DISC * * * *which relate to such gross receipts*." Treas. Reg. § 1.994-1(c)(6) (emphasis added). The DISC regulations then provide specific

guidance on how to conduct this calculation, explaining that costs

> which shall be treated as relating to gross receipts from sales of export property are (a) [those] *definitely related*, and therefore allocated and apportioned, thereto, and (b) a ratable part of other expenses * * * which are *not definitely related* to a class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8.

Treas. Reg. § 1.994-1(c)(6)(iii) (emphasis added).

This cross-reference in the DISC regulations to Treas. Reg. § 1.861-8 also grew out of the statutory background and harked back to the legislative history of the DISC statute. The committee reports explain that combined taxable income is to be determined "generally in accordance with the principles applicable under [IRC] section 861," one of the statutory provisions that classify income as either U.S. or foreign source income for U.S. income tax purposes. H.R. Rep. No. 533, *supra*, at 74. As the DISC legislative history emphasizes, IRC § 861 includes rules for determining the net income from a given source by "generally allocat[ing] to each item of gross income all expenses directly related thereto, and then apportion[ing] other expenses among all items of gross income on a ratable basis." *Ibid.*[3] Treas. Reg. § 1.861-8, which is cited in the DISC cost allocation regulation, "provided specific guidance for applying the allocation and apportionment rules referred to in IRC §§ 861, 862, and 863." *St. Jude Medical*, 34 F.3d at 1398. At the time the DISC legislation was enacted, Treas. Reg. § 1.861-8 "reiterated [IRC] § 861(b)'s language." *Id.* at 1402. See Treas. Reg. § 1.861-8 (1957).

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[3] IRC § 861(a) identifies income that is United States source gross income. IRC § 861(b) provides for determining net, taxable U.S. source income by subtracting from gross income "the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income."

The DISC regulations also address a second issue that is relevant to the calculation of tax-deferred export income. In allocating and apportioning costs so that they may be deducted from revenue, the regulations provide that the determinations may be made either on a transaction-by-transaction basis or, "at the annual choice of the taxpayer[,] * * * on the basis of groups consisting of products or product lines." Treas. Reg. § 1.994-1(c)(7)(i). The taxpayer's choice of a product or product line for these purposes is conclusive so long as it conforms *either* to "recognized industry or trade usage" *or* to "the 2-digit major groups * * * of the Standard Industrial Classification * * * of the Office of Management and Budget." Treas. Reg. § 1.994-1(c)(7)(ii). Thus, "[t]he taxpayer's choice [as to grouping] * * * shall be controlling, and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping." Treas. Reg. § 1.994-1(c)(6)(iv). Accordingly, when a taxpayer chooses to group its export sales by product, costs that definitely relate to each particular product group must be specifically allocated to that group, while costs that do not definitely relate to a particular product group must be apportioned among all relevant classes of income. Costs that relate to a particular product or product group *cannot* be allocated to any other product group, on a pro rata basis or otherwise.[4] These grouping procedures were contemplated by

[4] To illustrate, suppose that Megacorp, a U.S. conglomerate, makes and sells $100 worth of space shuttles, $100 worth of scooters, and $100 worth of pogo sticks during a particular year. All of the space shuttles are sold domestically to NASA, and all of the scooters and pogo sticks are exported through Megacorp's DISC. During the same year, Megacorp spends $30 to research fuel alternatives for its space shuttles, $10 to research scooter wheel technology, and nothing for pogo stick research. Megacorp also spends another $20 attempting to develop a new automobile that would recycle engine exhaust and $15 to research the impact of solar-generated neutrinos on the motion of all objects. Megacorp anticipates that its neutrino research might lead to improvements in any of its products or to entirely new products.

Congress. See H.R. Rep. No. 533, *supra*, at 74 ("Although * * * the pricing rules provided by the bill generally are to be applied on a product-by-product basis, the rules may be applied on the basis of product lines.").

2. The dispute now before the Court stems from a provision added to the IRC § 861 "sourcing" regulations in 1977, six years after enactment of the DISC statute and two years after issuance of the final DISC regulations in 1975. As a general matter, the 1977 revision of Treas. Reg. § 1.861-8 continued to "emphasize the factual relationship between the deduction and a class of gross income." Treas. Reg. § 1.861-8(b)(1). Revised Treas. Reg. § 1.861-8(e)(3), however, established a special rule for the allocation of research and development expenses, providing that such expenses "shall ordinarily be considered deductions which are definitely related to all income reasonably connected with the relevant broad product category * * * of the taxpayer" set forth in the Office of Management and Budget's Standard Industrial Classification ("SIC") Manual.[5] This regulation thus "deemed a definite relationship [to exist]

Under the DISC regulations, Megacorp can treat each of its four existing or nascent products as a separate group and calculate its total DISC income by adding up the separate net income (*i.e.*, CTI) attributable to its exported scooter and pogo stick groups. It does that by assigning its "definitely related" $10 of scooter R&D exclusively to its scooter group sales and apportioning its $15 of "indefinitely related" neutrino R&D in proportion to all of its current sales – $5 to scooters and $5 to pogo sticks (in each case, $15 x $100/$300). Megacorp's other R&D costs, for space shuttles and automobiles, are not relevant to the CTI calculations, because all of these costs "definitely relate" to existing or future products that Megacorp's DISC does not sell. Ignoring Megacorp's other costs, scooter CTI is thus $85 ($100 minus $10 minus $5), pogo stick CTI is $95 ($100 minus $5), and total CTI is $180.

[5] The provisions of Treas. Reg. § 1-861-8(e)(3) were renumbered in 1996 and, with amendments not relevant to this petition, were republished as Treas. Reg. § 1.861-17. See App., *infra*, 9a n.7.

between an expenditure for R&D and *all* income reasonably connected with a specific *broad product category*" (*St. Jude Medical*, 34 F.3d at 1399 (emphasis added)) – no matter how narrow or product-specific the actual focus of the R&D expense.[6]

3. For over 40 years, petitioner Boeing has been a world leader in commercial aircraft development and a major U.S. exporter of commercial aircraft. During the period at issue in this litigation, DISC-eligible export sales constituted approximately 70% of Boeing's commercial aircraft sales by dollar volume. Boeing exported commercial aircraft through a qualified export subsidiary. Before 1984, that subsidiary was Boeing International Sales Corporation, a qualified DISC; between 1984 and 1987, that subsidiary was Boeing Sales Corporation, a qualified FSC.

Boeing has maintained its leadership position by continuously developing new commercial aircraft. Consistent with industry practice, Boeing organizes its internal operations along product lines (*e.g.*, the 727, 737, and 757), each of which constitutes a separate "Program" within the Boeing organization. Management and staff for each Program are responsible for developing and managing a particular product line, including the line's various models and derivatives (for

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[6] Again consider Megacorp. Because all of Megacorp's diverse R&D pertains to products falling within SIC classification 37, which broadly covers all "transportation equipment," Treas. Reg. § 1.861-8(e)(3) would place the entirety of that R&D into a single pot and allocate the undifferentiated sum among all products in proportion to current sales. Thus, the exported scooters and pogo sticks each would attract $25 of R&D (total R&D of $75 x $100/$300), the CTI deemed attributable to each of those groups would be $75 ($100 minus $25), and total CTI would be $150 – in contrast to the $180 of total CTI that would result from applying the DISC regulations. This difference occurs because Treas. Reg. § 1.861-8(e)(3) mechanically reassigns to all products portions of all of Megacorp's R&D that in fact are "definitely related" to particular products.

example, passenger and cargo versions of the 747). App., *infra*, 16a.

As a leader in aviation technology, Boeing spends billions of dollars on research and development. Boeing allocates its R&D costs both *across* airplane Programs and directly *to* particular Programs, depending on the type of research. Some of Boeing's research is broad-based and aimed at advancing the state of the art for commercial aviation technology, including general avionics and aerodynamics research (such as wind tunnel tests to study wing airfoil designs and engineering analysis seeking ways to improve the weight and strength of airplanes). Boeing also conducts research to create and develop new products. Such research includes, for example, sketching and analyzing alternative fuselages, wings, and engines, as well as other technologies that could eventually be configured into a new commercial aircraft. Boeing refers to both of these types of general research and development as "Blue Sky R&D." App., *infra*, 2a-3a, 16a-17a.

In addition to this general R&D, Boeing engages in extensive R&D for each *particular* product line or type of aircraft that the company has decided to produce. Research and development to design, develop, test, and qualify the new aircraft for commercial service is a major component of each Program. For example, because each new aircraft has a unique configuration, Boeing engineers must specially design thousands of parts to fit the new aircraft's configuration and aerodynamic requirements. Similarly, Boeing must conduct extensive research and testing to ensure that a new aircraft will meet national and international safety standards. Research directly related to particular Programs constituted over 75% of Boeing's total R&D expenditures for the years at issue in this litigation. Boeing refers to the Program-specific research and development as "Program R&D" (or "Company Sponsored Product Development R&D"), because it is product-specific and generally not transferable to other Programs or aircraft. App., *infra*, 3a, 17a.

Mirroring its internal organizational structure, Boeing's accounting practices track costs and revenues along Program lines. Specifically, Boeing's cost accounting system allocates costs to the activity to which they are most closely related. Each airplane Program is a separate "final cost objective," and the accounting system allocates to each Program those costs directly related to it. The same is true for revenues. So, for example, the costs and sales of the 727 are accounted for separately from the 767, which are accounted for separately from the 777. In keeping with this framework, Boeing's cost accounting system allocates all research and development that is directly associated with a particular product line (the Program R&D) to that Program. However, costs for general research and development that are not directly related to a particular program (the Blue Sky R&D) are apportioned among Programs on a pro rata basis. For financial accounting and federal income tax purposes, Boeing deducts all research and development costs – including costs relating directly to a particular Program and those that must be apportioned among Programs – in the period in which they are incurred. This is true even if there are no corresponding sales in that period. App., *infra*, 3a, 17a-18a.

For DISC and FSC purposes, Boeing elected to treat each of its Programs as a separate product group, as permitted by Treas. Reg. § 1.994-1(c). Boeing used the CTI method to calculate the relevant income of each group. To determine CTI in each case, Boeing started with the product group's gross export receipts and subtracted from them the total combined costs of its export subsidiary and its United States operations that directly related to those export receipts, as well as a portion of its costs that did not directly relate to any Program. See App., *infra*, 3a, 17a. As part of this process, Boeing subtracted research and development costs from the revenues of each product group. Program R&D was attributed directly to the relevant Program; Blue Sky R&D was apportioned across Programs. *Id.* at 3a, 17a-18a.

4. After conducting an audit and reviewing Boeing's taxes for the years at issue (1979-1987), the IRS disallowed Boeing's method of allocating and apportioning its R&D costs and reallocated those expenses pursuant to Treas. Reg. § 1.861-8(e)(3). As noted above, that provision deems *all* of Boeing's R&D in any given year to be related to sales of *all* airplane models in that year, because all of Boeing's various commercial aircraft product lines fall into the single SIC Code 37 (transportation equipment). The IRS treated all R&D costs the same, without regard to their factual relationship to a particular product line. For example, the IRS allocated portions of the Program R&D costs that were attributable solely to aircraft still in the developmental stages (as were the 757 and 767 during some of the years at issue) to export sales generated by other Programs under which aircraft were actually in production and being sold during the years in question (such as the 747). The IRS apportioned costs in this manner even though the R&D expenditures associated with developing a new product line (such as the 767), obtaining FAA certification, and bringing it to market do not in any way contribute to the development of existing product lines (such as the 747). By reallocating $2 billion of research and development costs related to specific Boeing Programs and charging them against the revenues from other Programs, the IRS decreased the CTI upon which Boeing's export tax benefits were based and thereby increased Boeing's overall tax obligation for the years 1979 to 1987 by some $ 419 million. App., *infra*, 3a-4a, 18a.

Boeing paid the additional tax demanded by the IRS and filed suit seeking a refund. The district court ruled for Boeing, relying heavily on the Eighth Circuit's decision in *St. Jude Medical* and holding that Treas. Reg. § 1.861-8(e)(3) is invalid as applied to CTI computations. App., *infra*, 15a-24a. The district court pointed to three considerations supporting this conclusion. First, the court explained that, by mandating that export sales be grouped according to the broad SIC classifications, Treas. Reg. § 1.861-8(e)(3) conflicts with Treas.

Reg. §§ 1.994-1(c)(6)(iv) and (7), which provide that taxpayers may group income and allocate costs by product or product line. App., *infra*, 21a-22a. Second, the court reasoned that Treas. Reg. § 1.861-8(e)(3) creates an artificial "deemed" relationship between sales and R&D that conflicts with Congress's intent to "'generally allocate to each item of gross income all expenses *directly related thereto.*'" App., *infra*, 22a (quoting *St. Jude Medical*, 34 F.3d at 1401 (quoting H. Rep. No. 533, *supra*, at 74)) (emphasis in *St. Jude Medical*). And third, the court determined that Congress intended DISCs to deduct only those costs "'directly related to the production or sale of the export property'"; charging unsuccessful R&D that is never actualized as a successful product to current export sales of successful products through an artificial "deemed" relationship is "inconsistent" with that expressed intent. App., *infra*, 22a (quoting *St. Jude Medical*, 34 F.3d at 1401 (quoting H. Rep. No. 533, *supra*, at 74)). The district court thus concluded that the IRS erred in applying Treas. Reg. § 1.861-8(e)(3) to Boeing's CTI calculation, holding that Boeing was entitled to group its export sales by product line and allocate research and development expenditures accordingly.

On appeal, the Ninth Circuit reversed. App., *infra*, 1a-14a. The court of appeals opined that Treas. Reg. §§ 1.861-8(e)(3) and 1.994-1(c)(7) "can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become 'indirectly' or 'indefinitely' related to specific items of income. The taxpayer is required, nonetheless, to apportion these costs to broader categories of income and allocate them between the taxpayer's export and domestic sales by the proportional method set forth in Treas. Reg. § 1.861-8(e)(3)." App., *infra*, 12a. The Ninth Circuit also suggested that application of Treas. Reg. § 1.861-8(e)(3) in this context is supportable because, at the time of the enactment of the DISC statute, "Congress recognized [that] some of the costs incurred in a given tax year would not be 'directly related' to specific income items." App., *infra*, 11a. The court therefore held that,

as applied in this case, "Treas. Reg. § 1.861-8(e)(3) * * * is a reasonable interpretation of the applicable statutes and regulations." App., *infra*, 13a. In reaching this conclusion, the Ninth Circuit expressly "decline[d] to follow the reasoning of *St. Jude Medical*." App., *infra*, 10a.

REASONS FOR GRANTING THE PETITION

The decision below creates an express conflict with the holding of the Eighth Circuit on an important and recurring issue of federal law. This conflict plainly warrants the Court's attention. The existence of contrasting standards governing the treatment of R&D expenses in different circuits results in identically situated taxpayers being treated differently on the basis of geography; will generate a substantial volume of litigation; and creates considerable confusion in the operation of a tax incentive statute, an area where predictability and certainty are essential. The issue, moreover, is one of enormous practical importance: this case alone involves more than $400 million in tax liability, with billions of dollars potentially at stake across the Nation. Finally, the Ninth Circuit's decision frustrates the manifest intent underlying the DISC and related tax regimes, which Congress established to effectuate a vital international trade policy. Review by this Court therefore is imperative.

A. There Is An Express Conflict In The Circuits On Whether Treas. Reg. § 1.861-8(e)(3) May Be Applied To The Computation Of CTI

Review by this Court is necessary because there is a clear and irreconcilable conflict in the courts of appeals on a significant issue of federal law. The conflict is indisputable: the Ninth Circuit expressly, and candidly, "decline[d] to follow the reasoning of *St. Jude Medical*." App., *infra*, 10a.

On this point, the Ninth Circuit was correct: *St. Jude Medical* is indistinguishable from this case. In *St. Jude Medical*, as here, the taxpayer produced a number of devices

that were stipulated to be "separate products or product lines under recognized industry or trade usage." *St. Jude Medical*, 34 F.3d at 1401. In that case, as in this one, these separate products all fell into a single SIC classification. See *ibid.* In *St. Jude Medical*, as here, the taxpayer separately allocated R&D costs to each of the products with which they were actually associated, instead of apportioning them generally across the SIC category. See *id.* at 1396, 1400. And in that case, as in this one, the IRS disapproved the taxpayer's allocation of the R&D, contending that, under Treas. Reg. § 1.861-8(e)(3), *all* of the R&D costs relating to *all* products within the SIC classification had to be spread across the export receipts from *all* products within the classification. *Id.* at 1396, 1400.

The outcome in *St. Jude Medical*, however, was quite different from the one here. The Eighth Circuit rejected the IRS's position, "hold[ing] that § 1.861-8(e)(3) is invalid as applied to DISC CTI computations." 34 F.3d at 1396. The court reasoned that "[m]andating use of the SIC categories is inconsistent with Congress's intent to allow costs to be allocated on a product-by-product basis or on the basis of product lines." *Id.* at 1401. Moreover, the Eighth Circuit found that "the deemed relationship mandated by § 1.861-8(e)(3)(i) is inconsistent with Congress's intent to 'generally allocate to each item of gross income all expenses *directly related* thereto.'" *Ibid.* (quoting H.R. Rep. No. 533, *supra*, at 74 (emphasis added by the court)). And the court noted that mandatory use of the SIC categories, which had the effect of requiring that income from successful R&D "'bear the cost of unsuccessful research and development'" (*ibid.* (quoting Treas. Reg. § 1.861-8(e)(3)(i)), would be "inconsistent with Congress's stated intent" to deduct from DISC gross receipts those expenses that "'are directly related to the production or sale of * * * property.'" *Ibid.* (quoting H.R. Rep. No. 533, *supra*, at 74).

In reaching that conclusion, the Eighth Circuit acknowledged "a conflict between two Treasury regulations:

§ 1.994-1 and § 1.861-8. Section 1.994-1 allows the taxpayer's choice regarding the manner of grouping transactions to control. Section 1.861-8 mandates a specific method of grouping transactions." *St. Jude Medical*, 34 F.3d at 1402. In resolving this conflict, the court looked to the principles generally applicable under IRC § 861, concluding:

> An examination of § 861(b)'s language does not allow us to infer that Congress intended to impose mandatory SIC transaction grouping in CTI computations related to R & D expenditures. * * * In fact, § 1.861-8, at the time the DISC legislation was enacted, did not contain the SIC categories, but rather reiterated § 861(b)'s language.

St. Jude Medical, 34 F.3d at 1402 (footnote omitted). After examining "the origin and the purpose of the DISC statute," the Eighth Circuit accordingly held "that § 1.861-8 is unreasonable, and thus invalid, as applied to DISC CTI computations. * * * We believe Congress intended in CTI computations to allocate costs, such as R & D expenditures, to definitely related gross export receipts." *Ibid.*

In this case, the Ninth Circuit reached precisely the opposite conclusion. The Ninth Circuit expressly recognized the Eighth Circuit's holding "that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to DISC CTI computations" and "did not control the computation of DISC combined taxable income." App., *infra*, 10a. As we have explained, however, the Ninth Circuit went on to reject the Eighth Circuit's analysis. See *ibid.* The court below reasoned, instead, that "[the] statutory text does *not* confine the relevant costs to those 'definitely related' to sales of a particular product" (*id.* at 11a (emphasis added)); that "[t]here is *no* conflict between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(6)" (*id.* at 12a (emphasis added)); and that Treas. Reg. § 1.861-8(e))(3) "*is* a reasonable interpretation of the applicable statutes and regulations." App., *infra*, 13a (emphasis added).

The Ninth Circuit made no attempt to, and plainly could not, reconcile its holding with that of the Eighth Circuit in *St. Jude Medical*. Deciding cases that in all relevant respects are identical, the Eighth Circuit held that taxpayers are entitled to allocate R&D expenses on the basis of the specific product or product-line groupings that the DISC regulations authorize, while the Ninth Circuit held that same treatment impermissible, concluding that taxpayers instead must apportion R&D expenses on the basis of broad SIC classifications. As a result, identically situated taxpayers located in different parts of the country must bear dramatically different tax burdens. Because of the great need for "uniform application of the Internal Revenue laws" (*Turnbow* v. *Commissioner*, 368 U.S. 337, 339 (1961)), this intolerable situation warrants review by this Court.

B. The Decision Below Is Wrong

The need for review is particularly acute because the decision below is plainly wrong. The background and contemporaneous understanding of the DISC statute unmistakably establish two fundamental principles: (a) expenses that are *directly* related to a particular class of gross income must be allocated to that class and no other; and (b) taxpayers are entitled to select the grouping of products or product categories that they believe to be most advantageous. The court of appeals' decision departs from both of those principles. It thus frustrates the congressional intent and undermines the purposes of a significant federal tax incentive.

1. There is no denying that the Ninth Circuit's approach leads to perverse results. Under the court of appeals' holding, Boeing's R&D that relates exclusively to *one* specific airplane model has to be allocated, in large part, to revenue from the sale of *other*, unrelated models. Thus, if Boeing incurred a research expense in 1987 that was directed solely to improving a component unique to a new 767 model that was not yet in production, the Ninth Circuit would require treating the expense as part of the cost of that year's 747 sales – even

though *that* model of aircraft had been introduced years earlier and did not benefit at all from the R&D relating to 767s. Indeed, the court of appeals' holding would require that research expenses incurred in the development of *scooters or boats* be allocated, in part, to the production of *aircraft or space vehicles* because they all fall within the SIC Code (37) for "transportation equipment."

When it enacted the DISC statute, Congress certainly did not contemplate requiring such an outcome. To the contrary, the DISC regime was premised on the understanding that the income "attributable to" export sales under IRC § 994 would be calculated by allocating expenses to the class of income with which they are factually associated. The statute was enacted against the background of IRC § 861(b), which defines taxable income as gross income less [1] "the expenses * * * properly apportioned or allocated thereto and [2] a ratable part of any expenses * * * which cannot definitely be allocated to some item or class of gross income." Plainly, this scheme postulates that, if an expense *can* "definitely be allocated to some item or class of gross income," it falls into the first of these categories and therefore may *not* be ratably apportioned across all classes of income.

The legislative history of the DISC statute makes this point explicit, taking pains to spell out precisely the expense allocation scheme that Congress intended. The committee reports expressed Congress's intent that expense allocations under DISC "be determined generally in accordance with the principles applicable under section 861," observing that those IRC § 861 rules "generally allocate to each item of gross income all expenses directly related thereto." H.R. Rep. No. 533, *supra*, at 74. Applying this principle in the DISC context, the committee reports went on to declare that CTI is to be computed by subtracting from export revenue those "expenses * * * which were *directly related* to the production or sale of the export property and a portion of the * * * expenses *not allocable to any specific item of income*." *Ibid.* (emphasis

added). This system leaves no room for taking a portion of the expenses that *are* in fact related to particular export property and apportioning them to *other*, unrelated property.[7]

This understanding is confirmed by the DISC regulations that were promulgated almost contemporaneously with the enactment of the DISC statute. These rules identify the costs that "shall be treated as relating to gross receipts from sales of export property" as including both expenses that are "*definitely related*, and therefore allocated and apportioned, thereto," and "a ratable part of other expenses * * * which are *not definitely related to a class of gross income*." Treas. Reg. § 1.994-1(c)(6)(iii) (emphasis added). Again, this structure plainly contemplates that costs that *are* definitely related to particular products may not be allocated or apportioned to *other* products.

Moreover, at the time these regulations were promulgated it was clearly understood that a factual relationship had to exist between R&D expenditures and any "definitely related" income-producing activity to which those expenditures might be exclusively allocated. The final DISC allocation and apportionment regulation issued in 1975, Treas. Reg. § 1.994-1(c)(6)(iii), provides that these determinations are to be made "in a manner consistent with the rules set forth in [Treas. Reg.] § 1.861-8." As we have explained (at page 5, *supra*), the

[7] Aside from Treas. Reg. § 1.861-8(e)(3), the aberrational R&D regulation at issue here, Treasury regulations have themselves consistently recognized that the IRC § 861 regime contemplates a factual relationship between an expense and the class of income to which it is allocated. Treas. Reg. § 1.861-8(b) specifically notes that the allocation "rules emphasize the factual relationship between the deduction and a class of gross income." Indeed, the preamble accompanying the proposal of the Section 861 regulations on which the government relies in this case states: "If a proper allocation and apportionment of deductions *on the basis of factual relationships* is not accomplished, taxable income attributable to various sources will not be properly reflected under the applicable operative provisions of the Code." 41 Fed. Reg. 49,161 (Nov. 8, 1976) (emphasis added).

version of § 1.861-8 contemporaneously in force simply reiterated IRC § 861(b)'s language, distinguishing between expenses that can and cannot "definitely be allocated" to a class of income. And the proposed § 1.861-8 regulations in place in 1975 unambiguously applied the factual relationship principle to R&D in the DISC context. Those proposed regulations set forth the general rule as follows:

> Expenditures for research and development which a taxpayer deducts * * * shall be considered deductions which are definitely related to the class of gross income to which such research and development activity gives rise or is reasonably expected to give rise and shall be allocated to such class.

Prop. Treas. Reg. § 1.861-8(e)(3)(i) (1973). Example (1) in this proposed regulation illustrated the rule by treating four-, six-, and eight-cylinder gasoline engines as *separate* products, each with separate and directly allocable R&D. Example (2) extended this tracing of R&D to a DISC CTI computation in which four- and six-cylinder engines were grouped separately.[8]

Against this background, the Ninth Circuit plainly erred in holding that Treas. Reg. § 1.861-8(e)(3) could validly be applied in the circumstances of this case. That regulation irrebuttably deems *all* R&D expenses to be definitely related to *all* income within a broad SIC Code, so that the expenses must be spread over *all* products and product groups falling within that Code. This "deemed" relationship ignores the actual

[8] The Secretary of the Treasury evidently relied on these examples when including the reference to Treas. Reg. § 1.861-8 in the DISC regulations. The Technical Memorandum accompanying the final DISC regulations indicated that they did not include their own examples "for determining the portion of certain expenses of the [parent corporation] to be deducted in determining combined taxable income of the DISC and [the parent corporation]" because the drafters anticipated that the examples in the 1973 proposed § 1.861-8 regulations would apply. 1974 TM Lexis 30, at *20 (Oct. 29, 1974).

relationship between expense and income that Congress explicitly intended to govern CTI calculations under the DISC statute. The rule established by § 1.861-8(e)(3) also is contrary to the undisputed facts in this case, which establish that the research at issue here related to the design of *particular* airplane lines; it implements a regime in which narrowly focused research relating to the details of a new airplane is treated as a cost of selling an airplane that has been in production for 20 years; and it perverts the DISC scheme's central purpose by reducing the incentives that encourage exports. For these reasons, as the Eighth Circuit correctly held, "§1.861-8[(e)(3)] is unreasonable, and thus invalid, as applied to DISC CTI computations." *St. Jude Medical*, 34 F.3d at 1402.

2. The Ninth Circuit's holding that CTI must be calculated by apportioning expenses across all products within a broad SIC Code also is insupportable for a second, closely related reason: the DISC regulations emphatically state that the taxpayer is entitled to *choose* whether or not CTI determinations will be made on a product-by-product basis. The taxpayer is entitled to make this choice annually (see Treas. Reg. §1.994-1(c)(7)(i)) and its "choice [as to grouping] * * * shall be *controlling*." Treas. Reg. § 1.994-1(c)(6)(iv) (emphasis added). Indeed, the regulations specifically provide that the taxpayer's choice "will be accepted by [the IRS]" so long as it conforms *either* to "recognized industry or trade usage" *or* to "the 2-digit major groups * * * of the Standard Industrial Classification * * * of the Office of Management and Budget." Treas. Reg. § 1.994-1(c)(7)(ii). The DISC regulation, moreover, makes clear that the taxpayer's choice in this regard will determine the category of income to which expenses should be allocated in computing CTI: "costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year *resulting from such grouping*." Treas. Reg. § 1.994-1(c)(6)(iv) (emphasis added). This grouping rule was sufficiently important that Congress expressly incorporated it into both the FSC and ETI

statutes that succeeded DISC. IRC § 927(d)(2)(B) (1984); IRC § 943(b)(1)(B) (2000).

The Ninth Circuit's approach is flatly at odds with this principle. Rather than allocate costs to the classes of income "resulting from [the taxpayer's] grouping," as the DISC regulation mandates, the court of appeals requires that costs be allocated according to SIC Code. As the Eighth Circuit explained, "[m]andating use of the SIC categories is inconsistent with Congress's intent to allow costs to be allocated [either] on a product-by-product basis or on the basis of product lines." *St. Jude Medical*, 34 F.3d at 1401. Indeed, "[Treas. Reg.] § 1.861-8, at the time the DISC legislation was enacted, did not contain the SIC categories, but rather reiterated § 861(b)'s language." 34 F.3d at 1402. The decision below thus works a significant, and unwarranted, change in the incentives provided by the DISC statute and regulations.

The DISC provisions were specifically designed to encourage manufacturers to locate their productive facilities in the United States and to export their goods, rather than to supply their foreign markets from overseas factories. See H.R. Rep. No. 533, *supra*, at 58; S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971). To accomplish that result, Congress offered relief from taxation for a portion of the manufacturer's income "attributable to" (IRC § 994(a)(2)) sales of the exported goods. But by attributing millions of dollars of R&D expenses to export sales, even though the expenses in fact bore no relationship to those sales, the decision below artificially understates Boeing's true export sales income and reduces the incentive of U.S. companies to expand their domestic manufacturing operations. By contrast, the Eighth Circuit understood that this approach "may improperly decrease the profits allocated to a DISC, thus thwarting Congress's intent when it promulgated the DISC intercompany pricing rules." 34 F.2d at 1402-1403.

3. The rationales advanced by the Ninth Circuit cannot support its holding. *First*, the court of appeals opined that Treas. Reg. § 1.861-8(e)(3) and § 1.994-1(c) "can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become 'indirectly' or 'indefinitely' related to specific items of income." App., *infra*, 12a. This perplexing statement disregards *both* the controlling facts and the controlling law. The statement is flatly wrong as a factual matter, because it is undisputed that the R&D costs for each Boeing Program were *definitely* related to that Program and that Program alone, and were completely unrelated – "indefinitely" or otherwise – to other Programs. The Ninth Circuit's statement is equally indefensible as a legal proposition, because Treas. Reg. § 1.861-8(e)(3)(i) manifestly did *not* transform any R&D expenses into costs "'indefinitely' related to specific items of income." Instead, the regulation explicitly deems all R&D costs to be "*definitely* related to all income reasonably connected with the relevant [SIC] category" (emphasis added). Either way, the Ninth Circuit's purported "harmonization" of the regulations was nothing but rhetorical alchemy.

Second, the court of appeals may have meant to adopt the government's suggestion (see U.S. 9th Cir. Br. 11) that it was impermissible for Boeing to allocate R&D expenses to Programs that had no current gross income from which those expenses could be deducted. See App., *infra*, 3a (stating that such costs "simply 'disappeared'"). If so, the court plainly was incorrect. There is nothing inherently wrong in having the costs directly related to a particular product line exceed the gross income generated by that line in a given year. To the contrary, Treas. Reg. § 1.861-8(d) explicitly states that "[e]ach deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section [which emphasizes the "factual relationship between the deduction and a class of gross income"] even though, for the taxable year, *no gross income in*

such class is received" (emphasis added). Indeed, this principle was recognized even by the R&D allocation regulation itself. See Treas. Reg. § 1.861-8(e)(3)(ii)(B) ("[a]mounts apportioned under this paragraph (e)(3) may exceed the amount of gross income related to the product category within the statutory grouping."). See also IRC § 174 (general R&D incentive provision that allows R&D to be deducted in current year even though it may not generate income until future years); Treas. Reg. § 1.861-8(c)(1) ("In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping").

Third, the court of appeals found it significant that "Congress recognized [that] some of the costs incurred in a given tax year would not be 'directly related' to specific income items." App., *infra*, 11a. But that observation, while doubtless correct, is simply beside the point. That certain costs (*i.e.*, overhead) are not directly related to specific products hardly means that the costs that *are* directly related to specific products should be apportioned to *other* products. The Ninth Circuit's sleight-of-hand thus cannot obscure its departure from the fundamental principles underlying the DISC statute and regulations.

C. The Issue Presented Here Is A Recurring One Of Great Practical Importance

The question presented in this case has enormous practical significance. The Ninth Circuit's decision severely undermines the efficacy of an important export tax incentive program that has been used for decades by thousands of major U.S. manufacturers.

In its most recent (year 2000) analysis, the IRS reported that the number of FSC returns had risen to well over 4,000 in 1996, a 42% increase over the 3,073 FSC returns just filed four years

earlier.[9] Not only is the number of these taxpayers on the rise, but the amount of tax benefits is increasing as well. These companies' aggregate annual FSC tax benefits were estimated in February 2000 at approximately $4 billion for the year 2000, with a projected increase to $5.5 billion by the year 2005.[10] Estimates of total annual tax benefits from ETI, which replaced the FSC regime, begin at $4.8 billion for 2003, with the number projected to rise to $6.5 billion by the year 2007.[11]

Nearly 90% of all FSC returns filed for 1996 reported manufactured product exports, with nearly two-thirds of these revenues coming from exports of non-electrical machinery; transportation equipment; electrical machinery, equipment, and supplies; and chemicals and allied products.[12] Thus, thousands of FSCs are in industries with significant R&D expenditures, and the method of allocation of those expenditures can have a substantial effect on the amount of their tax-based export incentive. The resolution of the issue in this case will significantly affect many U.S. exporters that made substantial R&D expenditures during the years for which the FSC regime was in effect; as evidenced by the $419 million at issue in this case, the amounts at stake for any given taxpayer with regard to the R&D allocation issue can be very large. Equally

[9] Cynthia Belmonte, *Foreign Sales Corporations, 1996*, STATISTICS OF INCOME BULLETIN, Spring 2000 (published by the Internal Revenue Service).

[10] Office of Management and Budget, Budget of the U.S. Government, Fiscal Year 2001, Table 32-4, Tax Expenditures by Function for Fiscal Years 1999-2005, February 7, 2000.

[11] Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2002-2006, JCS-1-02, January 17, 2002.

[12] Cynthia Belmonte, *Foreign Sales Corporations, 1996*, STATISTICS OF INCOME BULLETIN, Spring 2000 (published by the Internal Revenue Service).

important, resolution of the issue will affect the behavior of thousands of taxpayers that must decide both whether to make substantial R&D expenditures on exports under the ETI regime and whether the tax incentives are sufficient to warrant an increase in exports.

Congress has long evidenced a concern for the competitiveness of the U.S. economy in the world market and has consistently sought to improve the U.S. balance of payments. Three decades ago, Congress determined that strong export incentives would promote those goals. In enacting the DISC provisions in 1971, Congress deviated from the general residence-based tax system of the U.S. (*i.e.*, taxing U.S. taxpayers on their worldwide income) and adopted a feature of territorial taxation (taxing only income earned in the U.S. and exempting or deferring some income of U.S. taxpayers earned abroad) that was designed to tax export sales more favorably than comparable domestic transactions.[13] These provisions, intended to level the playing field for U.S. exporters and to increase the volume of exports from the U.S., gave taxpayers considerable flexibility to maximize their tax benefits. It was no accident that the statutory scheme permitted taxpayers to

[13] See General Explanation of Tax Legislation Enacted in the 106th Congress, April 19, 2001, Joint Committee Print, 107th Cong., 1st Session. See also *Hearings on Trade Relations with Europe and the New Transatlantic Economic Partnership Before the Subcomm. on Trade of the House Comm. on Ways and Means*, 105th Cong., at 117 (1998) (statement of Jeremy O. Preiss, Chief International Trade Counsel, United Technologies Corporation) ("Congress enacted both the DISC and the FSC in part to begin leveling the playing field between the U.S. income tax system * * * and more export friendly territorial systems. The FSC is not a provision designed to confer a tax benefit on U.S. exporters that is not enjoyed by their competitors abroad; to the contrary, the FSC is designed to ameliorate – in quite small measure – a significant tax advantage that is enjoyed by companies exporting from countries with territorial tax systems.").

allocate their expenses, including R&D expenses, to product groups.

Congress has steadfastly adhered to this important policy in the face of repeated protests from other countries that these features of U.S. law provide illegal export subsidies. Thus, as noted above (see pages 2-3, *supra*), after the DISC regime was determined to violate international law, Congress enacted the FSC legislation. In that legislation, Congress pointedly codified the principles of the DISC regulations that permit taxpayers to maximize their tax incentive through the allocation of expenses to product groups. The ETI legislation, which was enacted in November 2000 after the FSC regime also was declared inconsistent with international obligations, includes an identical provision.[14] The FSC regulations remain in effect under the ETI regime to fill the gap before new regulations are promulgated.[15]

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[14] The statutory product grouping provisions for FSC (IRC § 927(d)(2)(B)) and ETI (IRC § 943(b)(1)(B)) both state as follows:

> Grouping of transactions. To the extent provided in regulations, any provision of this subpart [the overall FSC or ETI regime] which, but for this subparagraph, would be applied on a transaction-by-transaction basis may be applied by the taxpayer on the basis of groups of transactions based on product lines or recognized industry or trade usage. Such regulations may permit different groupings for different purposes.

[15] General Explanation of Tax Legislation Enacted in the 106th Congress, April 19, 2001, Joint Committee Print, 107th Cong., 1st Session. The importance of the issue presented here is not diminished by the recent decision of the World Trade Organization's Appellate Body that the current ETI regime is inconsistent with WTO rules, which authorizes the European Union to impose retaliatory tariffs against the United States. See WTO Report of the Appellate Body on Complaint of the European Communities Concerning United States Tax Treatment for "Foreign Sales Corporations," Daily Rep. for Executives, No. 10, at L-1 (Jan. 15, 2002). That decision does not displace U.S. law and the ETI system thus remains in effect. The

At bottom, the decision below ignores Congress' continuous support for the grouping rule and undermines a longstanding statutory policy designed to provide tax incentives for exports. Prior to the Ninth Circuit's decision, taxpayers could rely on statutory and regulatory language, the intent of Congress, and the Eighth Circuit's validation of that understanding in *St. Jude Medical* to compute export income in accordance with the DISC/FSC/ETI regulations, including the grouping rule. After the Ninth Circuit's decision, however, that benefit is available with certainty only to taxpayers in the Eighth Circuit. Thousands of taxpayers in other circuits will not be able to predict the magnitude of the export incentives promised to them by ETI (or its successor regime). Nor will those taxpayers be able to take advantage of those incentives as Congress intended without significant risk of an IRS challenge. Moreover, taxpayers outside the Eighth Circuit are now vulnerable to IRS claims for back taxes that would retroactively reduce the incentives upon which those taxpayers already have relied. The Court should resolve this dispute so that a single rule applies to export decision-making and tax liability throughout the United States.

WTO decision may be accessed at <www.wto.org/english/tratop_e/dispu_e/distabase_wto_members4_3.htm>.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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FEBRUARY 2002

APPENDIX

APPENDIX A

Nos. 99-35818 and 99-35857

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

THE BOEING COMPANY, and Consolidated Subsidiaries; BOEING SALES CORPORATION,
Plaintiffs-Appellees,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

THE BOEING COMPANY, and Consolidated Subsidiaries, Plaintiff, and BOEING SALES CORPORATION,
Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

April 4, 2001, Argued and Submitted,
Seattle, Washington
August 2, 2001, Filed

Before DAVID R. THOMPSON, TROTT, and PAEZ, Circuit Judges.

DAVID R. THOMPSON, Circuit Judge:

The United States appeals the district court's summary judgment determining that the Boeing Company and its consolidated subsidiaries ("Boeing") are entitled to an income tax refund of approximately $419 million for the years 1979 through 1987. The issue is how research and development costs ("R&D") should be accounted for computing Boeing's net

income from export sales of commercial airplanes under the Internal Revenue Code's export incentive provisions for a Domestic International Sales Corporation ("DISC") and a Foreign Sales Corporation ("FSC").

We have jurisdiction under 28 U.S.C. § 1291 (1994). We conclude that, in computing Boeing's net income, the Commissioner of Internal Revenue properly applied Treas. Reg. § 1.861-8(e)(3) to allocate Boeing's R&D costs to its export sales. Accordingly, we reverse the district court's summary judgment granting Boeing's tax refund claim.[1]

FACTS

From 1972 to 1984, Boeing exported commercial airplanes through its subsidiary, Boeing International Sales Corporation, which qualified as a DISC under Internal Revenue Code ("I.R.C.") § 992. After 1984, Boeing exported commercial airplanes through its subsidiary, Boeing Sales Corporation, which qualified as a FSC under I.R.C. § 922.

During the relevant period, Boeing maintained separate "programs" for each of its major commercial airplane product lines.[2] Each of Boeing's programs constitutes a separate product or product line under industry practice and trade usage in the commercial airplane business.

In developing these programs, Boeing segregated its R&D costs into two broad categories. The first category, Blue-Sky R&D, was for R&D costs incurred prior to Boeing's Board of

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[1] In view of our reversal of the summary judgment for approximately $419 million in favor of Boeing, we also reverse the district court's partial summary judgment for approximately $1 million in favor of the United States, pursuant to Boeing's conditional cross-appeal which the government does not oppose.

[2] During the tax years at issue, Boeing established or maintained a separate program for the following airplane models — 707, 727, 737, 737-300, 747, 757 and 767.

Directors giving approval for a new airplane model, which approval was referred to as "Program Go Ahead." Blue Sky R&D included basic research relating to commercial airplanes that might be the precursor to a specific program. The second category, Company Sponsored Product Development, was for costs incurred for a specific program after Program Go Ahead had been given for a particular airplane model and included the R&D cost of designing, developing, testing and qualifying that airplane. Approximately 77 percent of the R&D costs in the tax years at issue in this case fall within the Company Sponsored Product Development category.

For accounting purposes, Boeing apportioned Blue Sky R&D to all of its airplane programs, but allocated Company Sponsored Product Development R&D directly to the particular program for which those costs were incurred. Boeing deducted all R&D costs in the period in which they were incurred, regardless of whether there were any corresponding sales during that period. This meant that significant R&D costs for any new program could be allocated to that program in years prior to any sales of airplanes within that program.

Boeing used the combined taxable income method ("CTI") to calculate the intercompany price and profits from its export sales. See I.R.C. §§ 994(a)(2) & 925(a)(2). Pursuant to Treas. Reg. § 1.994-1(c)(7), Boeing grouped its export sales by program and apportioned costs, including R&D costs, to the particular airplane program for which those costs were incurred. If those R&D costs exceeded the amount of sales for the airplane program to which those costs were allocated, the excess of costs over sales, according to the IRS, simply "disappeared," in that those costs were not accounted for by Boeing in computing its CTI.

During an audit, the IRS determined that Boeing's method of allocating its R&D costs to its DISC and FSC sales violated Treas. Reg. § 1.861-8(e)(3), which requires all R&D costs to be allocated to and apportioned among all sales within the broad

product categories set forth in the Office of Management and Budget's Standard Industrial Classification ("SIC"). Because all of Boeing's commercial airplane sales fell within SIC code 37 (Transportation Equipment), the IRS allocated all of Boeing's R&D costs in a given period to all of Boeing's commercial airplane sales in that period. By this method of allocation, none of the R&D expenses "disappeared" (the government's characterization); instead, all of such expenses were charged to sales in the relevant period.

This method of allocation by the IRS caused a substantial decrease in Boeing's net income from its DISC and FSC sales. Because net income from such sales is accorded favorable tax treatment, Boeing's overall income tax liability, according to the IRS, was substantially understated.

Boeing paid the amount of additional tax required by the IRS, and timely filed claims for refund. When those claims were denied or not acted upon, Boeing filed this suit seeking a refund of corporate income taxes and interest in the total amount of $458,609,373. Both sides moved for summary judgment. The district court, relying on *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d 1394 (8th Cir. 1994), accepted Boeing's method of allocating R&D, and granted judgment in favor of Boeing for $419,110,539. This appeal followed.

ANALYSIS

We review de novo a district court's interpretation of the I.R.C. and corresponding treasury regulations. See *United States* v. *Hagberg*, 207 F.3d 569, 571 (9th Cir. 2000).

Generally, a court must defer to the Commissioner's interpretation of the I.R.C. by the regulations he issues, so long as those regulations "implement the congressional mandate in some reasonable manner." See *Redlark* v. *Commissioner*, 141 F.3d 936, 939 (9th Cir. 1998) (quoting *Rowan Cos.* v. *United States*, 452 U.S. 247, 252, 68 L. Ed. 2d 814, 101 S. Ct. 2288 (1981)). A court has authority to reject the Commissioner's

reasoned interpretation and invalidate a regulation only when the I.R.C. section to which the regulation applies has a meaning that is clear, unambiguous, and in conflict with the regulation. See *id.* (citing *Chevron U.S.A., Inc.* v. *Natural Res. Def. Council*, 467 U.S. 837, 841-44, 81 L. Ed. 2d 694, 104 S. Ct. 2778 (1984)).

When Congress, by explicitly leaving a gap for an agency to fill, delegates authority to the agency to elucidate a specific provision of a statute by regulation, that delegation is "express" and the agency's regulations issued pursuant to the legislation are "legislative regulations." Such regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. See 141 F.3d at 939-40 (citing *Chevron U.S.A., Inc.*, 467 U.S. at 843-44). If delegation to the agency is implicit, however, a court owes deference only to the agency's reasonable interpretation of the statutory provisions and related regulations. See *McLean* v. *Crabtree*, 173 F.3d 1176, 1181 (9th Cir. 1999), cert. denied, 528 U.S. 1086, 145 L. Ed. 2d 685, 120 S. Ct. 814 (2000).

Both Treas. Reg. §§ 1.861-8(e)(3) and 1.994-1(c) are legislative regulations because they were promulgated pursuant to I.R.C. §§ 863(a) and 994(b), which contain explicit grants of authority from Congress. See *Black & Decker Corp.* v. *Commissioner*, 986 F.2d 60, 63 (4th Cir. 1993) (explaining that section 863(a) provides express Congressional authorization for Treas. Reg. § 1.861-8, which describes the allocation of costs, losses, and deductions derived from domestic and foreign sources); see also I.R.C. § 994(b)(2) (granting the Secretary the authority to prescribe regulations "for the allocation of expenditures in computing combined taxable income. . . in those cases where a DISC is seeking to establish or maintain a market for export property").

In *St. Jude Medical*, however, the Eighth Circuit concluded that § 1.861-8(a)(3) was promulgated pursuant to the Commissioner's general grant of authority in I.R. C. § 7805(a),

not pursuant to any express legislative delegation, and as a result the court owed deference only to the IRS's reasonable interpretation of the applicable statutes and regulations. See *St. Jude Medical*, 34 F.3d at 1400 n. 11.

In the present case, we need not decide which standard of review applies, because whether we review the Commissioner's interpretation under an "arbitrary or capricious" standard, or under the arguably less deferential "reasonableness" standard, we uphold that interpretation. We agree with the Commissioner that Boeing's method of allocating R&D costs and calculating CTI on its DISC and FSC sales of commercial airplanes violates Treas. Reg. § 1.861-8(e)(3)'s requirement for the allocation of "total costs" and that Treas. Reg. § 1.861-8(e)(3) is a permissible interpretation of the I.R.C.

The DISC and FSC provisions permit a taxpayer to defer or exempt from tax a significant portion of income from export sales. See I.R.C. §§ 991-997; §§ 921-927.[3] These tax incentives are intended to encourage and increase exports by domestic corporations.

Qualified DISCs, which are subsidiaries incorporated under "the laws of any State," are not taxed directly.[4] I.R.C. § 992(a)(1). Instead, the parent corporation is taxed on a

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[3] The DISC provisions were enacted in 1971. The FSC provisions were enacted in 1984 to cure some problems with the DISC provisions. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494. Because the differences between these statutory schemes are not relevant to this appeal, we generally discuss only the DISC provisions.

[4] Prior to the enactment of the DISC legislation, domestic corporations which directly marketed their products in a foreign market were taxed on their foreign earnings "at the full U.S. corporate income tax rate regardless of whether [the] earnings [were] kept abroad or repatriated." H.R. Rep. No. 92-533, reprinted in 1971 U.S.C.C.A.N. 1825, 1872.

specified portion of its subsidiary DISC's profits. See I.R.C. § 995. The DISC's remaining profits are tax deferred until either they are distributed to the parent corporation or the DISC ceases to meet statutory requirements. See I.R.C. § 995(a) & (b).[5]

The amount of a DISC's profit depends on the transfer price at which its parent is deemed to have sold to it the product it resells. There are three methods for calculating this transfer price, and thus the amount of taxable income made on export sales. See I.R.C. § 994(a). These "intercompany pricing rules" are intended to "avoid the complexities of the [arm's-length] pricing rules . . . and also to provide encouragement for the operation of DISC's." H.R. Rep. No. 92-533, *reprinted* in 1971 U.S.C.C.A.N. 1825, 1887. Although the intercompany pricing rules permit a DISC to earn profits in excess of the arm's length pricing rules, they also serve to limit the amount of income which can be deferred from taxation. See *id.*; *Intel Corp.* v. *Commissioner*, 76 F.3d 976, 981 (9th Cir. 1995).

A taxpayer is permitted to choose the pricing method that maximizes its DISC's profit. See I.R. C. § 994. There is an incentive to maximize DISC profit because "[t] he greater the DISC profit, the larger the amount of tax-deferred income and the larger the deemed dividend." *St. Jude Medical*, 34 F.3d at 1397. Deemed dividends are taxed as foreign source income, which qualifies the parent corporation for a corresponding foreign tax credit. See I.R.C. §§ 862(a)(2), 901 & 904.

In computing its DISC profits, Boeing chose the combined taxable income (CTI) method described in I.R.C. § 994(a)(2), which permits such profits to be computed on the basis of fifty percent of the "combined taxable income . . . attributable to the qualified export receipts . . . ." The statute does not define

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[5] In contrast. a portion of a FSC's profits are permanently exempt from taxation. See I.R.C. § 923(a).

"combined taxable income." Instead, "combined taxable income" is defined in Treas. Reg. § 1.994-1(c)(6), which states:

> [T]he combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts (as defined in section 993(f)) of the DISC from such sale over the total costs of the DISC and related supplier *which relate* to such gross receipts.

26 C.F.R. § 1.994-1(c)(6) (emphasis added). Gross receipts are "the total receipts from the sale ... of property held primarily for sale ... in the ordinary course of trade or business, and gross income from all other sources," but do not include interest with respect to the sales. 26 U.S.C. § 993(f); 26 C.F.R. § 1.994-1(c)(6).

Generally, the pricing of goods sold by a supplier (the taxpayer) to its DISC should be made on a transaction-by-transaction basis. *Id.* § 1.994-1(c)(7). However, the taxpayer may elect to determine the price "on the basis of groups consisting of products or product lines." *Id.* The taxpayer's choice as to the grouping of transactions "shall be controlling," and "costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping." *Id.* § 1.994-1(c)(6)(iv). The district director must accept this determination if it conforms to a recognized industry or trade usage, or the major groups recognized by the SIC. *Id.* § 1.994-1(c)(7)(ii).

Before calculating DISC CTI, the taxpayer must allocate its costs between export sales and domestic sales. The costs of goods sold are determined according to 26 C.F.R. § 1.61-3. *Id.* § 1.994-1(c)(6)(ii). Other costs "which shall be treated as relating to the gross receipts from sales of export property are (a) the expenses, losses, and other deductions *definitely related*, and therefore allocated and apportioned, thereto, and (b) a ratable part of any other expenses, losses or other deductions which are *not definitely related* to a class of gross income,

determined in a matter consistent with the rules set forth in 1.861-8." *Id.* § 1.994-1(c)(6)(iii) (emphasis added).[6] Neither the § 1.994 regulations nor the I.R.C. define "definitely related" other than by reference to § 1.861-8.

Section 1.861-8(b)(2) states "[a] deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived." *Id.* § 1.861-8(b)(2). Recognizing that "research and development is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and development must bear the cost of unsuccessful research and development," § 1.861-8(e)(3)[7] provides:

> Expenditures for research and development which a taxpayer deducts under section 174 shall ordinarily be considered deductions which are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories) . . . . The individual products included within each category are enumerated in the . . . Standard Industrial Classification Manual.

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[6] The regulations offer the following as examples of deductions that are generally considered "not definitely related" to any class of gross income — personal interest expense, real estate and sales taxes, medical expenses, charitable contributions, and alimony payments. See 26 C.F.R. § 1.861-8(e)(9)(i) -(v).

[7] In 1996, the provisions of § 1.861-8(e)(3) were renumbered and, with amendments not relevant to this appeal, were republished as Treas. Reg. § 1.861-17.

The district court, relying on *St. Jude Medical*, determined that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to DISC CTI computations. In *St. Jude Medical*, the Eighth Circuit identified three reasons why § 1.861-8(e)(3) did not control the computation of DISC combined taxable income. See *St. Jude Medical*, 34 F.3d at 1401-02. First, the court determined that § 1.861-8(e)(3)'s requirement that the taxpayer group its sales under a broad SIC code conflicted with Congress's intent to permit taxpayers to allocate costs by product or product lines under § 1.994-1(c)(6)(iv) & (c)(7). *Id.* at 1401. Second, the court found section § 1.861-8(e)(3)(i)'s "deemed" relationship between R&D costs and export sales conflicted with Congress's intent to allocate to each item of gross income only the expenses directly related thereto. *Id.* Third, the court determined that § 1.861-8(e)(3)'s dictate that "gross income derived from successful research and development bear the cost of unsuccessful research and development" was inconsistent with Congress's intent that CTI computations include only those costs that are directly related to the production or sale of export property. *Id.* Applying a reasonableness standard of review,[8] the Eighth Circuit concluded that Treas. Reg. § 1.861-8(e)(3) was unreasonable and invalid as applied to Boeing's DISC CTI computations under § 1.994-1(c)(6) & (7). *Id.* at 1402.

We decline to follow the reasoning of *St. Jude Medical*. Instead, we agree with the Commissioner that Treas. Reg.

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[8] The Eighth Circuit considered "whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose." *Id.* at 1400 (quoting *Nat'l Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 477, 59 L. Ed. 2d 519, 99 S. Ct. 1304 (1979)). The court also considered "the span of time between the enactment of the statute and promulgation of the regulation, the length of time the regulation has been in effect, the evolution of the regulation, the reliance placed on the regulation, the consistency of the Commissioner's interpretation, and the degree of congressional scrutiny." *Id.*

§ 1.861 8(e)(3) is consistent with the guidance provided by the relevant I.R.C. provisions. Under I.R.C. § 994(a)(2), CTI is to be calculated based on revenue and costs "attributable to" sales in the applicable year. This statutory text does not confine the relevant costs to those "definitely related" to sales of a particular product.

The legislative history supports this position. The applicable House Report states:

> [T]he combined taxable income from the sale of the export property is to be determined generally in accordance with the principles applicable under section 861 for determining the source (within or without the United States) of the income . . . .These rules generally allocate to each item of gross income all expenses *directly related thereto*, and then apportion other expenses among all items of gross income on a ratable basis. Thus the combined taxable income . . . would be determined by deducting from the DISC's gross receipts the . . . cost of goods sold with respect to the property [and the expenses] of both the DISC and the related person which are *directly related* to the production or sale of the export property and a portion of the related person's and the DISC's expenses *not allocable to any specific item of income*, such portion to be determined based on the basis of the ratio of the combined gross income from the export property to the total gross income of the related person and the DISC.

H.R. Rep. No. 92-533, at 74, *reprinted in* 1971 U.S.C.C.A.N. 1825, 1887-1888 (emphasis added).

This House Report reflects that Congress recognized some of the costs incurred in a given tax year would not be "directly related" to specific income items. The Report further reflects Congress's intention that those costs not "directly related" would be allocated to export-related sales on a pro rata basis. The Commissioner's application of Treas. Reg. § 1.861-8(e)(3) effectuates this Congressional intent.

There is no conflict between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(6). The latter simply substitutes the term "definitely related" for "directly related." Like House Report 92-533, Treas. Reg. § 1.994-1(c)(6) contemplates that costs which are not "definitely related" to specific items of income in a given year will be allocated to the combined taxable income of the taxpayer's export-related business. Treas. Reg. § 1.994-1(c)(6) is clear in explaining that "total costs . . . which relate to" the receipts from export sales will be allocated to the combined taxable income from such sales and that those "total costs" include both "definitely" and "indefinitely" related costs.

To the extent there is any tension between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(7), the regulations can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become "indirectly" or "indefinitely" related to specific items of income. The taxpayer is required, nonetheless, to apportion these costs to broader categories of income and allocate them between the taxpayer's export and domestic sales by the proportional method set forth in Treas. Reg. § 1.861-8(e)(3).[9] Interpreted in this way, the regulations may be read to give effect to both. See, *e. g.*, *United States* v. *Borden Co.*, 308 U.S. 188, 198, 84 L. Ed. 181, 60 S. Ct. 182 (1939) ("It is a cardinal principle of construction that . . . [w]hen there are two acts upon the same subject, the rule is to give effect to both if possible."); see also *Black & Decker Corp.* v. *Commissioner*, 986 F.2d 60, 65 (4th Cir. 1993) (explaining that the tenets of statutory construction apply with equal force to the interpretation of regulations).

We are unpersuaded that Congressional inaction weighs in favor of either of the parties. Since 1977, when the IRS first

[9] If the regulations were truly in conflict, Treas. Reg. § 1.861-8(e)(3) would likely control as the later and more specific regulation. See *United States* v. *Carper*, 24 F.3d 1157, 1159 (9th Cir. 1994).

promulgated Treas. Reg. § 1.861-8(e)(3), Congress has both amended the DISC statutory scheme and enacted temporary legislation governing the allocation of R&D costs in other contexts. The government argues that Congress's failure to legislatively override Treas. Reg. § 1.861-8(e)(3) as to the computation of DISC CTI signals Congress's approval of that regulation's method for computing such income.[10] The tax court in *St. Jude Medical* relied in part on this argument. See *St. Jude Med., Inc.* v. *Commissioner*, 97 T.C. 457, 485 (1991) ("Congress has repeatedly considered the regulations at issue and ...has neither modified the allocation and apportionment regulations as applied to the computation of combined taxable income nor expressed its disapproval of the regulations."), *aff'd in part and rev'd in part by*, 34 F.3d 1394 (8th Cir. 1994). On the other hand, the Eighth Circuit discounted this argument in *St. Jude Medical*, 34 F.3d at 1402 n. 15, and Boeing argues Congress has failed to act in the seven years since the Eighth Circuit in *St. Jude Medical* determined that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to DISC income determinations. *Id.* at 1402.

The most that can be said from these competing arguments is that Congressional inaction provides no reliable indication of how this case should be resolved. Treas. Reg. § 1.861-8(e)(3), however, is a reasonable interpretation of the applicable statutes and regulations. As such, it provides the proper method for allocating Boeing's R&D costs attributable to its export sales of commercial airplanes. Accordingly, we reverse the district

[10] Beginning with the Economic Recovery Tax Act of 1981 § 223, Pub. L. No. 97-34, 95 Stat. 172, 249, Congress placed a two-year moratorium on Treas. Reg. § 1.861-8(e)(3) to the extent it was being used to determine whether particular income was foreign source or United States source income. This moratorium was extended an additional two years by the Deficit Reduction Act of 1984 § 126, Pub. L. No. 98-369, 98 Stat. 494, 648 and an additional year by the Consolidated Omnibus Budget Reconciliation Act of 1985 § 13211, Pub. L. No. 99-272, 100 Stat. 82, 324.

court's summary judgment for $419,110,539 in favor of Boeing. We also reverse the district court's partial summary judgment for approximately $1 million in favor of the government, and remand to the district court for further proceedings consistent with this opinion.

REVERSED and REMANDED.

APPENDIX B

No. C96-1990C

UNITED STATES DISTRICT COURT
for the Western District of Washington

THE BOEING COMPANY (and consolidated subsidiaries)
and BOEING SALES CORPORATION,
Plaintiffs,

v.

UNITED STATES OF AMERICA,
Defendant.

September 10, 1998, Decided

ORDER

COUGHENOUR, Chief Judge.

In this taxpayer refund case, the parties cross-move for summary judgment. Having considered all of the files and pleadings herein, and having heard oral argument, the Court GRANTS summary judgment in favor of plaintiffs.

INTRODUCTION

Plaintiffs ("Boeing") sue for the refund of over $446 million in federal income tax and assessed interest paid for the taxable periods 1979 through 1987. The case arises in the context of a special set of incentive provisions in the Internal Revenue Code ("IRC") allowing a U.S. taxpayer to defer or exempt from tax a portion of its net income on export sales if the property is sold through a subsidiary established as a domestic international sales corporation ("DISC") or a foreign sales corporation ("FSC"). Boeing thus has a substantial incentive under those provisions to increase net income from export sales by reducing the amount of deductions on its export sales. In the instant case, Boeing challenges the manner in which the IRS allocated and

apportioned over $1 billion in research and development ("R&D") costs in determining the net income of Boeing's DISC/FSC. Specifically, Boeing argues that Treasury Reg. § 1.861-8(e)(3) is illegal when applied to DISC/FSC combined taxable income ("CTI") computations.

FACTUAL BACKGROUND

The parties have stipulated to the facts relevant to the instant motions. During the years at issue, Boeing was the world's leading manufacturer of commercial airplanes and one of the country's largest exporters. On average, approximately 70% of Boeing's commercial airplane sales by dollar volume consisted of qualified export sales. From 1972 until 1984, Boeing exported commercial airplanes and related goods and services through its subsidiary, Boeing International Sales Corporation ("BISC"), a qualified DISC under I.R.C. § 992. After 1984, Boeing exported commercial airplanes and related goods and services through its subsidiary, Boeing Sales Corporation, a qualified FSC, under I.R.C. § 922.

For the time period in question, Boeing contends that it established or maintained separate Programs of each of its major commercial airplane product lines — the 707, the 727, the 737, the 747, the 767, the 757 and the 737-300. Within each Program, Boeing developed several different models (or "derivatives"), such as a passenger and cargo version of the 747. Each of Boeing's Programs is a separate product or product line in conformance with industry practice and trade usage in the commercial airplane business. The initial airplane in each of the Programs at issue, with the exception of the 737-300, was required to obtain a new type certification from the Federal Aviation Administration ("FAA"). The certificate sets forth the applicable regulatory requirements that the airplane has met.

Boeing classifies its R&D costs into two broad categories — "Blue-Sky R&D," incurred before the Program Go Ahead ("PGA") for a new airplane Program or major model derivative,

and Program R&D, also referred to as Company Sponsored Product Development ("CSPD"), incurred after PGA. CSPD expenditures represent approximately 77% of the R&D amounts at issue in this case. PGA is the point at which Boeing makes the firm business decision and commitment to produce a particular airplane model and the decision is made by the Board of Directors. Blue Sky R&D goes to basic research relating to commercial airplanes, such as research in the field of aerodynamics or avionics and to concept research aimed at identifying new commercial airplanes, that might adapt new technology to achieve a new market niche. Blue Sky R&D may be a precursor to a specifically identified Program, although the majority of Blue Sky projects never become Programs. CSPD is Program-specific and includes the cost of designing, developing, testing, and qualifying a particular new airplane model for commercial service with an FAA type certification. The majority of those costs are nonrecurring.

Under Boeing's cost accounting system, Blue-Sky R&D was allocated to all Programs and apportioned among them. CSPD R&D, on the other hand, was charged directly to the Programs in which they were incurred, and deducted on a current year bases regardless of whether there were any sales in the corresponding Program that year. During the years at issue, for financial accounting purposes, the Blue-Sky and CSPD R&D costs were expensed in the period in which they were incurred. And, for overall federal income tax purposes, all the R&D costs were deducted in the period they were incurred.

For purposes of calculating the intercompany price and profits from its export sales, Boeing chose the combined taxable income ("CTI") method under § 994(a)(2) and § 925(a)(2) of the Code. To calculate CTI, Boeing chose to "group" its export sales by airplane Program under Treas. Reg. § 1.994-1(c)(7). Boeing relied on its cost accounting system and the resulting identification of costs and expenses, including R&D, chargeable to the specific Program. Boeing's method charged the R&D to the specific program even if there were no

sales in the Program in the same year in which the CSPD R&D on that Program was incurred, and it would not be charged again against Program sales in later years.

Upon an audit, the IRS rejected Boeing's method of calculating CTI, claiming that Boeing's method made R&D effectively "disappear" for CTI purposes. The IRS instead applied Treas. Reg. § 1.861-8(e)(3), which provides that R&D expenses should be deemed related to all sales within the broad product categories set forth in the Standard Industrial Classification ("SIC") published by the Office of Management and Budget. All of Boeing's sales of commercial airplanes falls into SIC code 37, Transportation Equipment. Accordingly, for a given year, the IRS allocated all of Boeing's R&D expenses (Blue-Sky and CSPD) to all of Boeing's income from sales of commercial airplanes and then apportioned those R&D expenses among Boeing's airplane Programs on the basis of sales. All of the R&D is thus deducted against the revenue from Boeing's commercial airplanes sales for that year, whether or not the R&D is factually related to those sales.

ANALYSIS

Given the stipulated facts submitted by the parties, these summary judgment motions present a pure legal question: whether Treas. Reg. § 1.861-8(e)(3) may be applied to Boeing's DISC/FSC CTI computations. This is not a question of first impression. The Eight Circuit dealt with precisely this question in *St. Jude Medical, Inc.* v. *C.I.R.*, 34 F.3d 1394, 1396 (8th Cir. 1994). After examining the legislative intent behind the DISC and the applicable regulations, the Eight Circuit squarely held that "§ 1.861-8(e)(3) is invalid as applied to DISC CTI computations." The Court found that § 1.861-8(e)(3) was unreasonable as applied to the DISC statute as it did not "harmonize[] with the plain language of the statute, its origin, and its purpose." *Id.* at 1402. This Court finds the reasoning and

analysis in *St. Jude* to be persuasive and applicable to the current case.[1]

I. Statutory Framework

The *St. Jude* court set out in detail the statutory framework governing the calculation of CTI for a DISC/FSC, which this Court will summarize briefly. In 1971, Congress enacted the DISC provisions, I.R.C. §§ 991-997, as a tax incentive to encourage and increase exports of products by U.S. manufacturers. *St. Jude*, 34 F.3d at 1396. In 1984, the FSC provisions were enacted to replace and cure some shortcomings in the DISC provisions. Deficit Reduction Act of 1984, Pub. L. 98-369, § 801(a), 98 Stat. 494, 990; S. Rep. No. 98-169, at 636 (1984). Qualified DISC/FSC corporations are not subject to tax. Instead, the parent corporation is taxed on a specified portion of the DISC profits as a deemed distribution. I.R.C. § 995; *L&F Intl. Sales Corp.* v. *United States*, 912 F.2d 377, 378 (9th Cir. 1990). The remaining DISC profits are tax deferred until distributed to the parent or until the DISC ceases to qualify as a DISC. § 995(a) and (b). The FSC provisions permanently exempt a portion of FSC profits from tax. § 923(a).

Under the DISC statute, Congress also created intercompany pricing rules which provide for the price at which the parent corporation is deemed to have sold its products to the DISC corporation. The intercompany pricing rules were intended to "avoid the complexities of the [arms length] pricing rules in the

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[1] The *St. Jude* court said that a tax regulation must be a reasonable interpretation of the congressional mandate in order to be upheld. 34 F.3d at 1400. The government argues that the appropriate standard of review should be governed by the standard set forth in *Chevron USA* v. *Natural Resources Defense Council*, 467 U.S. 837, 81 L. Ed. 2d 694, 104 S. Ct. 2778 (1984). Even if that is the case, however, the *Chevron* standard still requires a reasonable interpretation of a statute. See *Redlark* v. *C.I.R.*, 141 F.3d 936, 939 (9th Cir. 1998) (courts "will not override the agency's reasonable construction" of statute). *St. Jude* found § 1.861-8(e)(3) to be an unreasonable construction.

case of sales by a domestic corporation . . . to a DISC and also to provide encouragement for the operation of DISC's." 34 F.3d at 1397 (quoting H.R. Rep. No. 533 at 73, reprinted in 1971 U.S.C.C.A.N. at 1887). The rules allowed a DISC corporation profit in excess of arm's length rules and regardless of the sales price actually charged. *Id.* The rules also served to "limit[] the amount of income of which the parent can defer realization," *Intel Corp.* v. *Commissioner*, 76 F.3d 976, 981 (9th Cir. 1995), by fixing a transfer price so that the entire amount of export sales would not be deferred, but only the amount computed under the statute.

Under the DISC intercompany pricing rules, taxpayers may choose between three pricing methods to achieve the largest amount of income allocation to DISC. See I.R.C. § 994. Boeing chose the combined taxable income, "CTI," method for its DISC/FSC. I.R.C. § 994(a)(2) states that the DISC is entitled to fifty percent of the "combined taxable income . . . attributable to the qualified export receipts" for the property.[2] The statute does not further define CTI. That definition is found in Treas. Reg. § 1.994-1(c)(6), which defines CTI as "the excess of gross receipts . . . from such a sale over the total costs of the DISC and related supplier which relate to such gross receipts."

Treas. Reg. § 1.994-1(c)(6)(iii) provides that the costs fall into three categories: (1) costs of goods sold, (2) costs that are "definitely related" to export property, and (3) costs that "are not definitely related to a class of gross income." Taxpayers must allocate their costs between export sales and domestic sales to compute CTI. Rather than creating a new method of cost allocation within the DISC provisions, Congress intended that CTI costs computations "be determined generally in

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[2] Although there are some differences between the DISC and FSC provisions, the parties agree that the calculation of the CTI on export sales is essentially the same for both. See *General Dynamics*, 108 T.C. 107 at 116.

accordance with the principles applicable under [I.R.C.] section 861." *St. Jude*, at 1401. Treas. Reg. § 1.861-8(e)(3) provides the general rules for allocating and apportioning R&D under I.R.C. § 861 and deems a definite relationship between an R&D expenditure and a broad SIC product category. 34 F.3d at 1399.

At the same time, Treas. Reg. § 1.994-1(c)(6)(iv) provides that the taxpayer's grouping choice under § 1.994-1(c)(7) "shall be controlling and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping." In this case, Boeing chose to group according to a recognized industry/trade usage, *i.e.* product line, and not the SIC code category, a choice that is not only allowed, but controlling.

II. The Application of § 1.861-8(e)(3) to DISC/FSC CTI Computations

The conflict between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(6)(iv) as applied to CTI computations was resolved in Boeing's favor in *St. Jude*. St. Jude was a U.S. corporation that incurred R&D related to three different products: an insulin pump, a cardiac pacemaker, and an artificial heart valve. St. Jude exported heart valves through its DISC, but never sold the insulin pump or cardiac pacemaker. St. Jude used the CTI method to calculate DISC transfer prices and grouped each of its three products separately under Treas. Reg. § 1.994-1(c)(6)(iv) and (c)(7), so that no portion of the R&D expenses for the insulin pump and pacemaker were allocated to export receipts from heart valves. The IRS applied § 1.861-8(e)(3) to all three products and grouped them under SIC Code 38, so that all R&D expenses effectively were charged against export sales of heart valves in computing CTI.

The *St. Jude* court found three primary defects with such an application of § 1.861-8(e)(3). The first defect is that the § 1.861-8(e)(3) requires grouping according to a two-digit SIC Code, which conflicts with Congress's intent to allow costs to

be allocated on a product-by-product basis or on the basis of product lines. See *St. Jude*, 34 F.3d at 1401. The second defect is that the "deemed" relationship mandated by § 1.861-8(e)(3) is inconsistent with Congress's intent to "generally allocate to each item of gross income all expenses *directly related thereto*." *St. Jude*, 34 F.3d at 1401 (emphasis in original). The third defect is that the SIC categories requiring "gross income derived from successful research and development [to] bear the cost of unsuccessful research and development" is inconsistent with Congress's intent to deduct only those costs "directly related to the production or sale of the export property." *Id.*

The government provides little resistance to the first two defects identified by *St. Jude*. It argues that there is no conflict between the mandated SIC grouping in § 1.861-8(e)(3) and the taxpayer elected grouping of § 1.994-1(c)(6)(iv) and (c)(7) because the grouping choice in § 1.861-8(e)(3) is somehow an exception to § 1.994-1(c)(6)(iv) when computing CTI. The government's only citation for that proposition, however, is the tax court decision in *St. Jude* which was reversed by the Eighth Circuit.

The government also argues that § 1.994-1(c)(6)(iv) and (c)(7) were merely for "administrative convenience" and using the grouping provisions to increase tax savings would be inconsistent with the purpose of CTI, which the government suggests is to limit the amount of tax savings available to taxpayers under the DISC/FSC provisions. The government reads too much into *Intel Corp.* in search of support for its proposition that CTI was meant to limit tax savings regardless of § 1.994-1(c)(6)(iv) and (c)(7). *Intel Corp.*'s description of the intercompany pricing rules merely recognizes that in the context of an incentive provision designed to allow "domestic exporters to enjoy a deferral of tax on their export earnings somewhat similar to that available to exporters who utilized foreign subsidiaries," [76 F.3d at 981, the exporters should enjoy a partial but not complete deferral.

The government seems to use the third defect as the basis for their argument that *St. Jude*'s holding should be limited to R&D on unsuccessful products. However, while the difference between successful and unsuccessful R&D was an important factor in *St. Jude*, its holding and analysis did not turn on that distinction. Indeed, it is the very nature of R&D that it cannot be known in advance whether or not the R&D effort will be successful and if successful, when it will be successful. If the development of a new product takes several years, it makes no sense for the taxpayer to apply Treas. Reg. § 1.861-8(e)(3) for the first years when the R&D has not resulted in sales, and then follow *St. Jude* in a subsequent year when there have been sales. Thus, although one of the defects of § 1.861-8(e)(3) is not applicable here, the other two are; and those defects are fatal.

The government also attempts to distinguish *St. Jude* by arguing that it did not address the issue of "total costs," referred to in § 1.994-1(c)(6), that is presented here. In fact, however, the *St. Jude* court rejected the government's argument that "total costs" should be calculated by deducting R&D from all export sales for the year, not just for a Program to which the R&D is related. *St. Jude* considered § 1.994-1(c)(6) and concluded that Congress intended an actual relationship, rather than a deemed relationship, between the export gross receipts and the expense in question, and that § 1.861-8(e)(3)'s "deeming" of a relationship violated Congress's intent. Thus, under *St. Jude*, "total costs" is calculated by deducting the R&D from the income to which the R&D is actually related, not from the total income of a DISC/FSC for any given year.

General Dynamics Corp. & Subsidiaries v. *Commissioner*, 108 T.C. 107 (1997), does not support the government's position either. Preliminarily, *General Dynamics* dealt with the definition of "total costs" on a very different set of facts. General Dynamics used the completed contract method of accounting for long-term contracts for federal income tax purposes. Normally, under the completed contract method, income and expenses connected with long-term contracts are

not reported or claimed until the completion of the contract, so General Dynamics did not recognize income from its long-term contracts until the year that the contract was completed. General Dynamics elected, however, to deduct certain period costs, including marketing and selling expenses, distribution expenses, pension and profit-sharing contributions, but not R&D, in the year incurred. The Tax Court found that those costs were not definitely related to income other than export sales, so they had to be accounted for in determining CTI when income was received from the completed contracts. 108 T.C. at 124-25.

More importantly, however, applying *General Dynamics* here would arrive at a result inconsistent with § 1.861-8(e)(3). The government's method of computing CTI reduces the CTI for a current Program within a given year (*i.e.*, sales of 747's in 1980) by the R&D incurred for a different Program that same year (*i.e.*, 757 R&D incurred in 1980). Under the approach in *General Dynamics*, however, because it is premised on the completed contract accounting method, current R&D (*i.e.*, 757 R&D incurred in 1980) would be currently deducted whether or not there was a sale in the Program, and not charged against the export sales in the Program until a sale was made (*i.e.*, 757 sales in 1981).

CONCLUSION

Accordingly, summary judgment is GRANTED in favor of plaintiffs.

APPENDIX C

No. 99-35818, 99-35857

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

THE BOEING COMPANY, and
Consolidated Subsidiaries; BOEING SALES
CORPORATION,
Plaintiffs-Appellees,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

THE BOEING COMPANY, and
Consolidated Subsidiaries, Plaintiff, and
BOEING SALES CORPORATION,
Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

November 19, 2001

Before: THOMPSON, TROTT, and PAEZ, Circuit Judges

The panel, as constituted above, has unanimously voted to deny appellee Boeing's petition for rehearing. Judges Trott and Paez have also voted to deny its petition for rehearing by the court en banc, and Judge Thompson has recommended that petition be denied.

The full court has been advised of the petition for court rehearing en banc, and no judge of the court has requested en banc rehearing. See Fed. R. App. P. 35(b).

The petition for panel rehearing and for rehearing by the court en banc are DENIED.

APPENDIX D

26 U.S.C. § 861 (1979)

§ 861. Income from sources within the United States.

(a) GROSS INCOME FROM SOURCES WITHIN UNITED STATES. – The following items of gross income shall be treated as income from sources within the United States:

* * *

(b) TAXABLE INCOME FROM SOURCES WITHIN UNITED STATES. – From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable par of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States. In the case of an individual who does not itemize deductions, an amount equal to the zero bracket amount shall be considered a deduction which cannot definitely be allocated to some item or class of gross income.

* * *

APPENDIX E

26 U.S.C. § 994 (1979)

§ 994. Inter-company pricing rules.

(a) In general. In the case of a sale of export property to a DISC by a person described in section 482, the taxable income of such DISC and such person shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—

(1) 4 percent of the qualified export receipts on the sale of such property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts,

(2) 50 percent of the combined taxable income of such DISC and such person which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or

(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).

(b) Rules for commissions, rentals, and marginal costing. The Secretary shall prescribe regulations setting forth—

(1) rules which are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals, and other income, and

(2) rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a DISC is seeking to establish or maintain a market for export property.

(c) Export promotion expenses. For purposes of this section, the term "export promotion expenses" means those expenses incurred to advance the distribution or sale of export property for use, consumption, or distribution outside of the

United States, but does not include income taxes. Such expenses shall also include freight expenses to the extent of 50 percent of the cost of shipping export property aboard airplanes owned and operated by United States persons or ships documented under the laws of the United States in those cases where law or regulations does not require that such property be shipped aboard such airplanes or ships.

APPENDIX F

26 C.F.R. 1.994-1 (1979)

§ 1.994-1 Inter-company pricing rules for DISC's.

(a) In general -- (1) Scope. In the case of a transaction described in paragraph (b) of this section, section 994 permits a person related to a DISC to determine the allowable transfer price charged the DISC (or commission paid the DISC) by its choice of three methods described in paragraph (c) (2), (3), and (4) of this section: The "4 percent" gross receipts method, the "50-50" combined taxable income method, and the section 482 method. Under the first two methods, the DISC is entitled to 10 percent of its export promotion expenses as additional taxable income. When the gross receipts method or combined taxable income method is applied to a transaction, the Commissioner may not make distributions, apportionments, or allocations as provided by section 482 and the regulations thereunder. For rules as to certain "incomplete transactions" and for computing combined taxable income, see paragraph (c) (5) and (6) of this section. Grouping of transactions for purposes of applying the method chosen is provided by paragraph (c)(7) of this section. The rules in paragraph (c) of this section are directly applicable only in the case of sales or exchanges of export property to a DISC for resale, and are applicable by analogy to leases, commissions, and services as provided in paragraph (d) of this section. For rules limiting the application of the gross receipts method and combined taxable income method so that the supplier related to the DISC will not incur a loss on transactions, see paragraph (e)(1) of this section. Paragraph (e)(2) of this section provides for the applicability of section 482 to resales by the DISC to related persons. Paragraph (e)(3) of this section provides for the time by which a reasonable estimate of the transfer price (including commissions and other payments) should be paid. The subsequent determination and further adjustments to transfer prices are set forth in paragraph (e)(4) of this section. Export promotion expenses are defined in

paragraph (f) of this section. Paragraph (g) of this section has several examples illustrating the provisions of this section. Section 1.994-2 prescribes the marginal costing rules authorized by section 994(b)(2).

* * *

(c) Transfer price for sales of export property – (1) In general. Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a DISC in the case of a sale of export property described in paragraph (b)(1) of this section.

(2) The "4-percent" gross receipts method. Under the gross receipts method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 4 percent of the qualified export receipts of the DISC derived from the sale of the export property (as defined in section 993 (c)) and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(3) The "50-50" combined taxable income method. Under the combined taxable income method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 50 percent of the combined taxable income (as defined in subparagraph (6) of this paragraph) of the DISC and its related supplier attributable to the qualified export receipts from such sale and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(4) Section 482 method. If the rules of subparagraphs (2) and (3) of this paragraph are inapplicable to a sale or a taxpayer does not choose to use them, the transfer price for a sale by the related supplier to the DISC is to be determined on

the basis of the sale price actually charged but subject to the rules provided by section 482 and the regulations thereunder.

(5) Incomplete transactions. (i) For purposes of the gross receipts and combined taxable income methods, where property (encompassed within a transaction or group chosen under subparagraph (7) of this paragraph) is transferred by a related supplier to a DISC during a taxable year of either the DISC or related supplier, but some or all of such property is not sold by the DISC during such year –

(a) The transfer price of such property sold by the DISC during such year shall be computed separately from the transfer price of the property not sold by the DISC during such year,

(b) With respect to such property not sold by the DISC during such year, the transfer price paid by the DISC for such year shall be the related supplier's cost of goods sold (see subparagraph (6)(ii) of this paragraph) with respect to the property, except that, with respect to such taxable years ending on or before August 15, 1975, the transfer price paid by the DISC shall be at least (but need not exceed) the related supplier's cost of goods sold with respect to the property.

(c) For the subsequent taxable year during which such property is resold by the DISC, an additional amount shall be paid by the DISC (to be treated as income for such year by the related supplier) equal to the excess of the amount which would have been the transfer price under this section had the transfer to the DISC by the related supplier and the resale by the DISC taken place during the taxable year of the DISC during which it resold the property over the amount already paid under (b) of this subdivision.

(d) The time and manner of payment of transfer prices required by (b) and (c) of this subdivision shall be determined under paragraph (e) (3), (4), and (5) of this section.

(ii) For purposes of this paragraph, a DISC may determine the year in which it receives property from a related supplier

and the year in which it sells property in accordance with the method of identifying goods in its inventory properly used under section 471 or 472 (relating respectively to general rule for inventories and to LIFO inventories). Transportation expense of the related supplier in connection with a transaction to which this subparagraph applies shall be treated as an item of cost of goods sold with respect to the property if the related supplier includes the cost of intracompany transportation between its branches, divisions, plants, or other units in its cost of goods sold (see subparagraph (6)(ii) of this paragraph).

(6) Combined taxable income. For purposes of this section, the combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts (as defined in section 993(f)) of the DISC from such sale over the total costs of the DISC and related supplier which relate to such gross receipts. Gross receipts from a sale do not include interest with respect to the sale. Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) of this section all adjustments required by section 482 with respect to transactions to which section is applicable. In determining the gross receipts of the DISC and the total costs of the DISC and related supplier which relate to such gross receipts, the following rules shall be applied:

(i) Subject to subdivisions (ii) through (v) of this subparagraph, the taxpayer's method of accounting used in computing taxable income will be accepted for purposes of determining amounts and the taxable year for which items of income and expense (including depreciation) are taken into account. See § 1.991-1(b)(2) with respect to the method of accounting which may be used by a DISC.

(ii) Cost of goods sold shall be determined in accordance with the provisions of § 1.61-3. See sections 471 and 472 and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631

applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying § 1.631-1 (d)(3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).

(iii) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are (a) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (b) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8.

(iv) The taxpayer's choice in accordance with subparagraph (7) of this paragraph as to the grouping of transactions shall be controlling, and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping.

(v) If an account receivable arising with respect to a sale of export property is transferred by the related supplier to a DISC which is a member of the same controlled group within the meaning of § 1.993-1(k) for an amount reflecting a discount from the selling price taken into account in computing (without regard to this subdivision) combined taxable income of the DISC and its related supplier, then the combined taxable income from such sale shall be reduced by the amount of the discount.

(7) Grouping transactions. (i) Generally, the determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice of the taxpayer some or all of these determinations may be made on the basis of groups consisting of products or product lines.

(ii) A determination by a taxpayer as to a product or a product line will be accepted by a district director if such determination conforms to any one of the following standards: (a) A recognized industry or trade usage, or (b) the 2-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.

(iii) A choice by the taxpayer to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are made on a transaction-by-transaction basis. For example, the taxpayer may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year.

(iv) For rules as to grouping certain related and subsidiary services, see paragraph (d)(3)(ii) of this section.

* * *

APPENDIX G

26 C.F.R. § 1.861-8 (1979)

§ 1.861-8 Computation of taxable income from sources within the United States and from other sources and activities

(a) *In general* – (1) *Scope.* Sections 861(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined. Sections 862(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources without the United States after gross income from sources without the United States has been determined. This section provides specific guidance for applying the cited Code sections by prescribing rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively in this section as "deductions") of the taxpayer. The rules contained in this section apply in determining taxable income of the taxpayer from specific sources and activities under other sections of the Code, referred to in this section as operative sections. See paragraph (f)(1) of this section for a list and description of operative sections. The operative sections include, among others, sections 8761(b) and 882 (relating to taxable income of a nonresident alien individual or a foreign corporation which is effectively connected with the conduct of a trade or business in the United States), section 904(a)(1) (as in effect before enactment of the Tax Reform Act of 1976, relating to taxable income from sources within specific foreign countries), and section 904(a)(2) (as in effect before enactment of the Tax Reform Act of 1976, or section 904(a) after such enactment, relating to taxable income from all sources without the United States).

(2) *Allocation and apportionment of deductions in general.* A taxpayer to which this section applies is required to allocate deductions to a class of gross income and then, if necessary to make the determination required by the operative section of the

Code, to apportion deductions within the class of gross income between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income. Except for deductions, if any, which are not definitely related to gross income (see paragraphs (c)(2) and (e)(9) of this section) and which, therefore, are ratably apportioned to all gross income, all deductions of the taxpayer (except the deductions for personal exemptions enumerated in paragraph (e)(11) of this section) must be so allocated and apportioned. As further detailed below, allocations and apportionments are made on the basis of the factual relationship of deductions to gross income. If an affiliated group of corporations joins in filing a consolidated return under section 1501, the provisions of this section are to be applied separately to each member in that affiliated group for purposes of determining such member's taxable income.

* * *

(b) *Allocation* – (1) *In general.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items of gross income. The rules emphasize the factual relationship between the deduction and a class of gross income. See paragraph (d)(1) of this section which provides that in a taxable year there may be no item of gross income in a class or less gross income than deductions allocated to the class, and paragraph (d)(2) of this section which provides that a class of gross income may include excluded income. Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income (without regard to the tax-payable year in which such gross income is received or accrued or is expected to be received or accrued). The classes of gross income are not predetermined but must be determined on the basis of the deductions to be allocated. Although most deductions will be definitely related to some class of a

taxpayer's total gross income, some deductions are related to all gross income. In addition, some deductions are treated as not definitely related to any gross income and are ratably apportioned to all gross income. (See paragraph (e)(9) of this section.) In allocating deductions it is not necessary to differentiate between deductions related to one item of gross income and deductions related to another item of gross income where both items of gross income are exclusively within the same statutory grouping or exclusively within the residual grouping.

(2) *Relationship to activity or property.* A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income, such deduction shall be considered definitely related to such gross income as a class whether or not there is any item of gross income in such class which is received or accrued during the taxable year and whether or not the amount of deductions exceeds the amount of the gross income in such class. See paragraph (d)(1) of this section and example (17) of paragraph (g) of this section with respect to cases in which there is an excess of deductions. In some cases, it will be found that this subparagraph can most readily be applied by determining, with respect to a deduction, the categories of gross income to which it is not related and concluding that it is definitely related to a class consisting of all other gross income.

(3) *Supportive functions.* Deductions which are supportive in nature (such as overhead, general and administrative, and supervisory expenses) may relate to other deductions which can more readily be allocated to gross income. In such instance, such supportive deductions may be allocated and apportioned

along with the deductions to which they relate. On the other hand, it would be equally acceptable to attribute supportive deductions on some reasonable basis directly to activities or property which generate, have generated, or could reasonably have been expected to generated gross income. This would ordinarily be accomplished by allocating the supportive expenses to all gross income or to another broad class of gross income and apportioning the expenses in accordance with paragraph (c)(1) of this section. For this purpose, reasonable departmental overhead rates may be utilized. For examples of the application of the principles of this paragraph (b)(3) other than to expenses attributable to stewardship activities, see examples (19) through (21) of paragraph (g) of this section. See paragraph (e)(4) of this section for the allocation and apportionment of deductions attributable to stewardship activities.

(4) *Deductions related to a class of gross income.* See paragraph (e) of this section for rules relating to the allocation and apportionment of certain specific deductions definitely related to a class of gross income. See paragraph (c)(1) of this section for rules relating to the apportionment of deductions.

(5) *Deductions related to all gross income.* If a deduction does not bear a definite relationship to a class of gross income constituting less than all of the gross income, it shall ordinarily be treated as definitely related and allocable to all of the taxpayer's gross income except where provided to the contrary under paragraph (e) of this section. Paragraph (e)(9) of this section lists various deductions which generally are not definitely related to any gross income and are ratably apportioned to all gross income.

(c) *Apportionment of deductions* – (1) *Deductions definitely related to a class of gross income.* Where a deduction has been allocated in accordance with paragraph (b) of this section to a class of gross income which is included in one statutory grouping and the residual grouping, the deduction must be

apportioned between the statutory grouping and the residual grouping. Where a deduction has been allocated to a class of gross income which is included in more than one statutory grouping, such deduction must be apportioned among the statutory groupings and, where necessary, the residual grouping. If the class of gross income to which a deduction has been allocated is included in its entirety in either a single statutory grouping or the residual grouping, there is no need to apportion that deduction. If a deduction is not definitely related to any gross income, it must be apportioned ratably as provided in paragraph (c)(2) of this section. A deduction is apportioned by attributing the deduction to gross income (within the class to which the deduction has been allocated) which is in the statutory grouping or in each of the statutory groupings and to gross income (within the class) which is in the residual grouping. Such attribution must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. In apportioning deductions, it may be that for the taxable year there is no gross income in the statutory grouping or that deductions will exceed the amount of gross income in the statutory grouping. See paragraph (d)(1) of this section with respect to cases in which there is an excess of deductions. In determining the method of apportionment for a specific deduction, examples of bases and factors which should be considered include, but are not limited to–

(i) Comparison of units sold attributable to the statutory grouping and attributable to the residual grouping;

(ii) Comparison of the amount of gross sales or receipts;

(iii) Comparison of costs of goods sold;

(iv) Comparison of profit contribution;

(v) Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to the

activities or properties giving rise to the class of gross income; and

(vi) Comparison of the amount of gross income in the statutory grouping with the amount in the residual grouping.

Paragraphs (e)(2) through (e)(8) of this section provide the applicable rules for allocation and apportionment of deductions for interest, research, and development expenses, and certain other deductions. The effects on tax liability of the apportionment of deductions and the burden of maintaining records not otherwise maintained and making computations not otherwise made shall be taken into consideration in determining whether a method of apportionment and its application are sufficiently precise. A method of apportionment described in this paragraph (c)(1) of this section may not be used when it does not reflect, to a reasonably close extent, the factual relationship between the deduction and the groupings of income. The principles set forth above are applicable in apportioning both deductions definitely related to a class which constitutes less than all of the taxpayer's gross income and to deductions related to all of the taxpayer's gross income. If a deduction is not definitely related to any class of gross income, it must be apportioned ratably as provided in paragraph (c)(2) of this section.

(2) *Deductions not definitely related to any gross income.* If a deduction is not definitely related to any gross income (see paragraph (e)(9) of this section), the deduction must be apportioned ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping. Thus, the amount apportioned to each statutory grouping shall be equal to the same proportion of the deduction which the amount of gross income in the statutory grouping bears to the total amount of gross income. The amount apportioned to the residual grouping shall be equal to the same proportion of the deduction which the amount of the gross

income in the residual grouping bears to the total amount of gross income.

(d) *Excess of deductions and excluded and eliminated income* – (1) *Excess of deductions.* Each deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section even though, for the taxable year, no gross income in such class is received or accrued or the amount of the deduction exceeds the amount of such class of gross income. In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping (or residual grouping), or that deductions exceed the amount of gross income in the statutory grouping (or residual grouping). If there is no gross income in a statutory grouping or the amount of deductions allocated and apportioned to a statutory grouping exceeds the amount of gross income in the statutory grouping, the effects are determined under the operative section. If the taxpayer is a member of a group filing a consolidated return, such excess of deductions allocated or apportioned to a statutory grouping of income of such member is taken into account in determining the consolidated taxable income from such statutory grouping, and such excess of deductions allocated or apportioned to the residual grouping of income is taken into account in determining the consolidated taxable income from the residual grouping. See § 1.1502-4(d)(1) and the last sentence of § 1.1502-12. For an illustration of the principles of this paragraph (d)(1), see example (17) of paragraph (g) of this section.

(2) *Allocation and apportionment to exempt, excluded or eliminated income.* In allocating or apportioning deductions to classes or statutory groupings of gross income, including apportionment pursuant to paragraph (c)(2) of this section (deductions not definitely related to any class of gross income), gross income shall include amounts which are otherwise exempt or excluded (such as the income of a nonresident alien individual or foreign corporation which is not effectively

connected income) or which are otherwise eliminated in the computation of consolidated taxable income reported for the taxable year on a consolidated return (but deferred intercompany transactions, as defined in § 1.1502-13, shall not be included until the year they are included in taxable income). Hence, a deduction may be allocated and apportioned to exempt, excluded, or eliminated income. See example (24) of paragraph (g) of this section. No deduction shall be allowed, under this section, for any amount, or part thereof, allocable and apportionable to a class of exempt, excluded, or eliminated income, if such amount is not allowed as a deduction under another section of the Code. See section 265 and the regulations thereunder.

(e) *Allocation and apportionment of certain deductions* – (1) *In general* Subparagraphs (2) and (3) of this paragraph contain rules with respect to the allocation and apportionment of interest expense and research and development expenditures, respectively. Subparagraphs (4) through (8) of this paragraph contain rules with respect to the allocation of certain other deductions. Subparagraphs (9) of this paragraph lists those deductions which are ordinarily considered as not being definitely related to any class of gross income. Subparagraph (10) of this paragraph lists special deductions of corporations which must be allocated and apportioned. Subparagraph (11) of this paragraph lists personal exemptions which are neither allocated nor apportioned. Examples of allocation and apportionment are contained in paragraph (g) of this section.

* * *

(3) *Research and experimental expenditures* – (i) *Allocation* – (A) *In general.* The methods of allocation and apportionment of research and development set forth in this paragraph (e)(3) recognize that research and development is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and development must bear the cost of

unsuccessful research an development. Expenditures for research and development which a taxpayer deducts under section 174 shall ordinarily be considered deductions which are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories). For purposes of this allocation, the product category (or categories) which a taxpayer may be considered to have shall be limited to the following list. Ordinarily a taxpayer's research and development expenditures may be divided between the relevant product categories. Where research and development is conducted with respect to more than one product category, the taxpayer may aggregate the categories for purposes of allocation and apportionment; however, the taxpayer may not subdivide the categories in this list. Where research and development is not clearly identified with any product category (or categories), it will be considered conducted with respect to all the taxpayer's product categories. The individual products included within each category are enumerated in Executive Office of the President, Office of Management and budget, Standard Industrial Classification Manual, 1972 (or later edition, as available).

SIC Major Groups	*Nonmanufactured categories*
(01, 02 ,07, 08, 09).....	Agriculture, forestry and fisheries.
(10, 11, 12)	Hard mineral mining.
(13)	Crude petroleum, and natural gas.
(14)	Nonmetallic minerals.
(15, 16, 17)	Construction services.
(40, 41, 42, 43, 44, 45, 46, 47)	Transportation services.
(48)	Communication.

SIC Major Groups	*Nonmanufactured categories*
(49)	Electric, gas and sanitary services.
(50, 51)	Wholesale trade (not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories and not applicable with respect to a domestic international sales corporation for which the taxpayer is a related supplier of goods and services from any other of the taxpayer's product categories).
(52, 53, 54, 55, 56, 57, 58, 59)	Retail trade (not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories, except Wholesale trade, and not applicable with respect to a domestic international sales corporation for which the taxpayer is a related supplier of goods and services from any other of the taxpayer's product categories, except Wholesale trade).
(60, 61, 62, 63, 64, 65, 66, 67)	Finance, insurance, and real estate.
(70, 72, 73, 75, 76, 78, 79, 80, 81, 82, 83, 84, 86, 88, 89)	Other services.
(20)	Food and kindred products.
(21)	Tobacco manufacturers.
(22)	Textile mill products.

SIC Major Groups	*Nonmanufactured categories*
(23)	Apparel and other finished products made from fabrics and similar materials.
(24)	Lumber and wood products, except furniture.
(25)	Furniture and fixtures.
(26)	Paper and allied products.
(27)	Printing, publishing, and allied industries.
(28)	Chemicals and allied products.
(29)	Petroleum refining and related industries.
(30)	Rubber and miscellaneous plastics products.
(31)	Leather and leather products.
(32)	Stone, clay, glass and concrete products.
(33)	Primary metal industries.
(34)	Fabricated metal products, except machinery and transportation equipment.
(35)	Machinery, except electrical.
(36)	Electrical and electronic machinery, equipment and supplies.
(37)	Transportation equipment.

SIC Major Groups	*Nonmanufactured categories*
(38)	Measuring, analyzing, and controlling instruments; photographic, medical and optical goods, watches and checks.
(39)	Miscellaneous manufacturing industries.

(B) *Exception.* Where research and development is undertaken solely to meet legal requirements imposed by a political entity with respect to improvement or marketing of specific products or processes, and the results cannot reasonably be expected to generage amounts of gross income (beyond de minimis amounts) outside a single geographic source, the deduction for such research and development shall be considered definitely related and therefore allocable only to the grouping (or groupings) of gross income within that geographic source as a class (and apportioned, if necessary, between such groupings as set forth in subdivisions (ii)(B) and (iii) of this paragraph (e)(3)). For example, where a taxpayer performs tests on a product in response to a requirement imposed by the U.S. Food and Drug Administration, and the test results cannot reasonably be expected to generate amounts of gross income (beyond de minimis amounts) outside the United States, the costs of testing shall be allocated solely to gross income from sources within the United States.

(ii) *Apportionment of research and development – sales method* – (A) *Exclusive apportionment.* Where an apportionment based upon geographic sources of income of a deduction for research and development is necessary (after applying the exception in subdivision (i)(B) of this paragraph (d)(3), an amount equal to –

(1) Fifty percent (50%), in the case of a taxable years beginning during 1977.

(2) Forty percent (40%), in the case of a taxable year beginning during 1978.

(3) Thirty percent (30%), in the case of a taxable year beginning during 1979, and thereafter,

of such deduction for research and development shall be apportioned exclusively to the statutory grouping of gross income, or the residual grouping of gross income, as the case may be, arising from the geographic source where the research and development activities which account for more than fifty percent (50%) of the amount of such deduction were performed. If the fifty percent test of the preceding sentence is not met, then no part of the deduction shall be apportioned under this subdivision (ii)(A). This exclusive apportionment reflects the view that research and development is often most valuable in the country where it is performed, for two reasons. First, research and development often benefits a broad product category, consisting of many individual products, all of which may be sold in the nearest market but only some of which may be sold in foreign markets. Second, research and development often is utilized in the nearest market before it is used in other markets, and in such cases, has a lower value per unit of sales when used in foreign markets. The taxpayer may establish to the satisfaction of the Commissioner that, in its case, one or both of the conditions mentioned in the preceding sentences warrant a significantly greater percent then the relevant percent specified in *(1)*, *(2)* or *(3)* of this subdivision (ii)(A) because the research and development is reasonably expected to have very limited or long delayed application outside the geographic source where it was performed. For purposes of establishing that only some products within the product category (or categories) are sold in foreign markets, the taxpayer shall compare the commercial production of individual products in domestic and foreign markets made by itself, by uncontrolled parties (as defined under (C) of this subdivision (ii)) of products involving intangible property which was licensed or sold by the taxpayer, and by those controlled corporations (as

defined under (D) of this subdivision (ii)) which can reasonably be expected to benefit directly or indirectly from any of the taxpayer's research expense connected with the product category (or categories). The individual products compared for this purpose shall be limited, for non-manufactured categories, solely to those enumerated in Executive Office of the President, Office of Management and Budget *Standard Industrial Classification Manual*, 1972 or later edition, as available), and, for manufactured categories, solely to those enumerated at a 7-digit level on pages 5 through 200 of U.S. Bureau of the Census, *Census of Manufactures: 1972, Numerical List of Manufactured Products (New (1972) SIC Basis)*, 1973, (or later edition, as available). Examples (9), (10), and (13) in paragraph *(g)* of this section illustrate the application of this rule. For purposes of establishing the delayed application of research findings abroad, the taxpayer shall compare the commercial introduction of its own particular products and processes (not limited by those listed in the *Standard Industrial Classification Manual or the Numerical List of Manufactured Products)* in the United States and foreign markets, made by itself, by uncontrolled parties (as defined under (C) of this subdivision (ii)) of products involving intangible property which was licensed or sold by the taxpayer, and by those controlled corporations (as defined under (D) of this subdivision (ii)) which can reasonably be expected to benefit, directly or indirectly, from the taxpayer's research expense. For purposes of evaluating the delay in the application of research findings in foreign markets, the taxpayer shall use a safe haven discount rate of 10 percent per year of delay unless he is able to establish, by reference to the cost of money and the number of years during which economic benefit can be directly attributable to the results of taxpayer's research, that another discount rate is more appropriate (see examples (9) through (12) in paragraph (g) of this section).

(B) *Remaining apportionment.* The amount equal to the remaining portion of such deduction for research and

development, not apportioned under (A) of this subdivision (ii), shall be apportioned between the statutory grouping (or among the statutory groupings) within the class of gross income and the residual grouping within such class in the same proportions that the amount of sales from the product category (or categories) which resulted in such gross income within the statutory grouping (or statutory groupings) and in the residual grouping bear, respectively, to the total amount of sales from the product category (or categories). For the purposes of this paragraph *(e)(3)*, amounts received from the lease of equipment during a taxable year shall be regarded as sales receipts for such taxable year. Amounts apportioned under this paragraph *(e)(3)* may exceed the amount of gross income related to the product category within the statutory grouping. In such case, the excess shall be applied against other gross income within the statutory grouping. See paragraph (d)(1) of this section for instances where the apportionment leads to an excess of deductions over gross income within the statutory grouping.

(C) *Sales of uncontrolled parties.* For purposes of the apportionment under (B) of this subdivision (ii), the sales from the product category (or categories) by each party uncontrolled by the taxpayer, of particular products involving intangible property which was licensed or sold by the taxpayer to such uncontrolled party shall be taken fully into account both for determining the taxpayer's apportionment and for determining the apportionment of any other member of a controlled group of corporations to which the taxpayer belongs if the uncontrolled party can reasonably be expected to benefit directly or indirectly (through any member of the controlled group of corporations to which the taxpayer belongs) from the research expense connected with the product category (or categories) of such other member. In the case of licensed products, if the amount of sales of such products is unknown (for example, where the licensed product is a component of a large machine), a reasonable estimate should be made. In the case of sales of intangible property, and in cases where a

reasonable estimate of sales of licensed products cannot be made, the sales taken into account shall be an amount which is ten times the amount received or secured for the intangible during the taxpayer's taxable year. For purposes of this subdivision (ii)(C), the term "uncontrolled party" means a party which is not a person with a relationship to the taxpayer (specified in section 267(b)), or is not a member of a controlled group of corporations to which the taxpayer belongs (within the meaning of section 993 (a)(3). An uncontrolled party can reasonably be expected to benefit from the research expense of a member of a controlled group of corporations to which the taxpayer belongs if such member can reasonably be expected to license, sell, or transfer intangible property to that uncontrolled party, or transfer secret processes to that uncontrolled party, directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs.

(D) *Sales of controlled parties.* For purposes of the apportionment under purposes of the apportionment under (B) of this subdivision (ii), the sales from the product category (or categories) of the taxpayer shall be taken fully into account and the sales from the product category (of categories) of a corporation controlled by the taxpayer shall be taken into account to the extent provided in *(1)* or *(2)* of this subdivision (ii)(D) for determining the taxpayer's apportionment, fi such corporation can reasonably be expected to benefit directly or indirectly (through another member of the controlled group of corporations to which the taxpayer belongs) from the taxpayer's research expense connected with the product category or categories). However, sales from the product category (or categories) between or among such controlled corporations or the taxpayer shall not be taken into account more than once; in such a situation, the amount sold by the selling corporation to the buying corporation shall be subtracted from the sales of the buying corporation. For purposes of this subdivision (ii)(D), the term "a corporation controlled by the taxpayer" means any

corporation other than an "uncontrolled party" as defined in (C) of this subdivision (ii). A corporation controlled by the taxpayer can reasonably be expected to benefit from the taxpayer's research expense if the taxpayer can be exptected to license, sell, or transfer intangible property to that corporation, or transfer secret processes to that corporation, either directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs. Past experience with research and development shall be considered in determining reasonable expectations. However, if the corporation controlled by the taxpayer has entered into a bonafide cost-sharing arrangement, in accordance with the provisions of § 1.482-2(d)(4), with the taxpayer for the purpose of developing intangible property, then that corporation shall not reasonably be expected to benefit from the taxpayer's share of the research expense. The sales from the product category (or categories) of a corporation controlled by the taxpayer taken into account shall be the greater of–

(1) The amount of sales that would have been taken into account under paragraph (e)(3)(ii)(C) of this section if the controlled corporation were an uncontrolled party and if any intangible property contributed by the taxpayer to the controlled corporation were treated as a license of that intangible property; or

(2) The amount of sales that bear the same proportion to total sales of the controlled corporation as the taxpayer's direct or indirect ownership, as defined in section 1563, of the total combined voting power of all classes of stock entitled to vote of such corporation bears to the total outstanding combined voting power of all such classes of stock of such corporation.

(iii) *Apportionment of research and development – optional gross income methods.* If the conditions of either (A) or (B) of this subdivision (iii) are met, in lieu of apportioning the deduction for research and development expense under

subdivision (ii) of this paragraph (e)(3), a taxpayer may, at his option, for any taxable year apportion such deduction, as prescribed in (A) or (B) of this subdivision (iii), between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income. These optional methods must be applied to the taxpayer's entire deduction for research and development expense remaining after applying the exception in subdivision (i)(B) of this paragraph (e)(3), and may not be applied on a product category basis. However, if any member of an affiliated group which files a consolidated return apportions its research and development expense for a taxable year under this subdivision (iii), then all members joining that return must use this subdivision (iii) for such taxable year.

(A) *Option One.* If, when apportioned ratably on the basis of gross income between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income in the same proportions that the amount of gross income in the statutory grouping (or groupings) and the amount of gross income in the residual grouping bear, respectively, to the total amount of gross income.

(1) The amount of research and development expense ratably apportioned to the statutory grouping (or groupings in the aggregate) is not less than fifty percent (50%) of the amount which would have been so apportioned if the taxpayer had used the method described in subdivision (ii) of this paragraph (e)(3), and

(2) The amount of research and development expense ratably apportioned to the residual grouping is not less than fifty percent (50%) of the amount which would have been so apportioned if the taxpayer had used the method described in subdivision (ii) of this paragraph (e)(3).

then the taxpayer may apportion his research and development expense ratably on the basis of gross income.

(B) *Option Two.* If, when the amount of research and development expense is apportioned ratably on the basis of gross income, either condition (1) or (2) of (A) of this subdivision (iii) is not met, the taxpayer may either:

(1) Where condition (1) of (A) of this subdivision (iii) is not met, apportion fifty percent (50%) of the amount of research and development expense which would have been apportioned to the statutory grouping (or groupings in the aggregate) under subdivision (ii) of this paragraph (e)(3) to such statutory grouping (or to such statutory groupings in the aggregate and then among such groupings on the basis of gross income within each grouping), and apportion the balance of the amount of research and development expenses to the residual grouping; or

(2) Where condition (2) of (A) of this subdivision (iii) is not met, apportion fifty percent (50%) of the amount of research and development expense which would have been apportioned to the residual grouping under subdivision (ii) of this paragraph (e)(3) to such residual grouping, and apportion the balance of the amount of research and development expenses to the statutory grouping (or to the statutory groupings in the aggregate and then among such groupings ratably on the basis of gross income within each grouping).

(iv) *Examples.* Examples (3) through (16) and example (23) of paragraph (g) of this section illustrate the allocation and apportionment of research and development deductions.

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